CHAPTER 2

Mark-to-Market Accounting

The second part of trader tax status is the opportunity for qualified traders to elect mark-to-market (MTM) accounting (Internal Revenue Code § 475). This code section has the effect of converting capital gains and losses into ordinary gains and losses. Short-term capital gains are taxed the same as ordinary gains, but ordinary losses are far superior to capital losses. By default, traders and investors use the cash method of accounting, which means trading gains and losses are treated as capital gains and losses subject to the wash sale loss-deferral rules, and capital loss limitations.

Mark-to-market refers to the procedure you follow at year-end, when you mark all your open positions to market prices. In effect, you are calculating a sale of all open positions (long and short) at year-end using the year-end market prices. On the first day of the following year, you input the buy-back of those positions at the same market prices. In effect, you end up reporting on your tax return all realized and unrealized gains and losses. MTM converts unrealized positions to realized positions for tax purposes.

MTM is similar to the accrual method of accounting in the sense that the economic reality—not just the cash settlement, as would be done using the cash method of accounting—is reported on your tax returns. MTM only applies to trading gains and losses; it does not apply to a trader's business expenses, as would the accrual method of accounting. A trader may elect MTM for trading gains and losses and use the accrual or cash method of accounting for business expenses.

By default, all traders and investors use the cash method of accounting for trading gains and losses, and their trading expenses. A trader in securities and/or commodities who qualifies as "being in the business of trading" may elect to use MTM for trading gains and losses.

MTM trading gains and losses differ from the amount of gains and losses you would have using the cash method. The difference is the year-end MTM unrealized trading gains and losses that are calculated as realized.

MTM trading gains and losses are considered ordinary gains and losses, and they are reported on Form 4797 (Sale of Business Property). *Ordinary* is the key word; it means that trading losses may be deducted in full against any type of tax return income (ordinary, passive, investment, capital). Ordinary business losses (MTM trading losses) comprise part of one's net operating losses (NOLs), which are net business losses for the tax year. NOLs may be carried back up to two years for immediate tax refunds (on Form 1045 or Form 1040X). Or, you can elect to forgo an NOL carry back and carry forward the NOL twenty years. NOLs not used up in prior years are automatically carried forward.

Ordinary MTM trading gains are taxed at ordinary tax rates, which are the taxpayer's marginal tax rates. Short-term capital gains, using the cash method, are also taxed at ordinary tax rates, which eliminates any difference between MTM and the cash method as it applies to short-term gains on securities. MTM would not apply to a trader's segregated investment positions (i.e., a joint investment account held with a spouse), so one does not give up the opportunity to benefit from long-term capital gains tax rates, which are significantly lower than ordinary tax rates (e.g., 15 percent instead of 35 percent).

If you want to elect mark-to-market (MTM) accounting treatment for your current tax year (and future years), you need to attach an election to your prior year tax return or extension and file it by the due date of your prior year tax return (April 15 for individuals and March 15 for calendaryear corporations). The election process is important. If you make any mistakes or file it late, you will lose out on these trader tax benefits.

When you change your accounting method from cash to MTM for the current tax year, you need to also later file a Form 3115 (Change of Accounting Method) with the filing of your current year's tax return. Do not panic—the Form 3115 is not filed with your MTM election by April 15. This change of accounting is automatic, meaning you do not require consent from the IRS (as some other changes of accounting method require). Two steps are necessary in electing MTM; first electing it on time, and later filing the Form 3115. Make sure to do both properly or you will jeopardize your MTM election and usage. That error can cost you up to 40 percent (assumed tax rates) of your trading losses when it comes to claiming a refund. For example, elect MTM on April 15, 2004 for tax year 2004. Next, file a Form 3115 with your 2004 federal tax return in 2005, by the 2004 tax return due date including extensions. Many traders make a serious error by filing a Form 3115 in lieu of the election statement on April 15, 2004—a one-step process. The IRS most likely will return that filing and that trader won't have MTM.

You also will need to calculate and report a Section 481(a) adjustment on the Form 3115 and on your tax return Form 4797. A Section 481 adjustment is intended to report the accounting effect of changing your accounting method. If you elect MTM for the current tax year, you need to start your accounting on January 1 with all open positions valued at market prices on January 1. When you ended the prior tax year, you were using the cash method of accounting, which means all open positions were valued at cost. Hence, the section 481 adjustment is the difference in those open positions at cost versus the January 1 market values (prior year-end prices).

Your section 481 adjustment is your unrealized gain or loss on securities held in your trading business as of the end of the prior tax year. Remember, cash method traders only report their realized gains and losses in the prior tax year.

If your section 481 adjustment is positive, you are required to prorate the adjustment on your income tax return over four years. If it is less than

$25,000, you may use the "de minimis rule" and report the entire amount in the year of change.

Negative section 481 adjustments are 100 percent deductible in the year of change. Rev. Proc. 2002-9 and Rev. Proc. 2002-19 provide that, in the case of changes in method of accounting that result in a negative (i.e., taxpayer-favorable) IRC § 481(a) adjustment, the entire amount of the adjustment will be taken into account in the year of change. This rule change applies to 2001 and later years.

For example, a 2004 section 481 adjustment on January 1, 2004, in the amount of $40,000 is reported as $10,000 (one-quarter) on your 2004 tax return (Form 4797, Sale of Business Property), and the remaining three-quarters is divided evenly over the following three tax years (providing you remain in the trading business). If you exit the trading business, you must accelerate the entire remaining income adjustment to that tax year. If you have a deferred income adjustment, plan for this taxable income in later years.

MTM ELECTION STATEMENT TO USE

The IRS has not yet provided taxpayers with a form to use for the MTM election, as they indicated in the MTM tax laws. In lieu of a tax form, you may attach the following election statement to your prior year federal tax return or extension (Form 4868), which states:

> Pursuant to IRC 475(f), the Taxpayer hereby elects to adopt the mark-to-market method of accounting for the tax year ended December 31, 2005 year, and subsequent tax years. The election applies to the following trade or business: Trader in Securities as a sole proprietor.

Be careful to change this statement to commodities, or securities and commodities as appropriate.

Note: we don't recommend IRC § 475 for commodities, for the following reasons.

Some nuances are involved in electing MTM. If you have a large capital loss carryover, you cannot apply it against future MTM trading gains (capital losses can only be offset against capital gains). Many traders face this predicament: they want MTM "loss insurance," but they also want to use up their carryover capital losses.

Caution: Please note that when a partner contributes an asset to a partnership where the asset has a "built-in" capital loss in the hands of the partner (i.e., the cost basis of the asset is more than the fair market value at the date of the contribution to the partnership), the loss from the sale of the asset is still treated as a capital loss by the partnership if the asset is sold within five years of the date it was contributed to the partnership. This treatment is true even if the partnership has trader status and has properly elected MTM. IRC § 724(c) specifically prevents the conversion of built-in capital losses on security transactions to ordinary losses by contributions from a cash basis trader/investor to a trading entity that has properly elected MTM. This section applies also to an LLC, including a single-member LLC. However, it does not apply to S-corporations. Our firm, GreenTraderTax, has found a few exceptions to this rule so see our updates area.

A Missed Mark-to-Market Election for the Current Tax Year

If you missed the mark-to-market election deadline for the current year (by April 15), you can still benefit from the first part of trader tax status, reporting your trading business expenses on a Schedule C. You might also file an extension with a Private Letter Ruling or form an entity which may elect MTM within seventy-five days of inception.

Extensions for MTM Elections

If you miss the MTM election by April 15, and you act by October 15, you may be able to receive an extension of time to file your current year MTM election. Reg § 301.9100-1 "Extensions of time to make elections" provides relief for late elections. Note the maximum extension period is six months. One big catch, you need to file a Private Letter Ruling.

Private Letter Rulings

In order to file an extension for an MTM election, you must file a Private Letter Ruling (PLR). The PLR procedure is painstaking and expensive, and for traders seeking relief to use MTM, the chance of success is extremely small. To date, the IRS website has published only four PLRs for traders seeking to use MTM, and all have been denied.

It is useful to read the IRS rulings for the 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.

www.irs.gov/pub/irs-wd/0209052.pdf
www.irs.gov/pub/irs-wd/0209053.pdf
www.irs.gov/pub/irs-wd/0209054.pdf
www.irs.gov/pub/irs-wd/0304006.pdf

Net Operating Losses

Business taxpayers are allowed a special huge tax benefit: net operating loss (NOL) tax laws. These laws provide the opportunity to carry back and/or forward business losses. Make a fortune in one year and pay your taxes, then lose a fortune in the following years and carry back your NOLs to get huge refunds of taxes paid in the prior (profitable) years. MTM is an important component of NOLs

Securities Trading

Securities business traders should elect mark-to-market accounting for several reasons. In the event they lose money trading in any given year, which is highly likely because of the ups and downs of the trading business, they are protected with MTM tax loss insurance. Electing MTM allows them to get immediate tax refunds on their unlimited ordinary trading losses. Non-MTM traders using the default cash method of accounting are stuck with capital loss carryovers that may never result in a tax refund (unless they generate capital gains in future years).

Profitable securities business traders do not need tax loss insurance, and they want to know what MTM has to offer them. The answer is that with MTM, traders are exempt from the onerous wash sale loss-deferral rules (and straddles and constructive receipt rules) that apply to non-MTM traders and all investors. For example, a non-MTM trader might be profitable for the year, but may also have hundreds of wash sale loss transactions during (and especially toward the end) of the tax year. These wash sale losses are deferred to the following tax year, thereby increasing the non-MTM trader's tax bill significantly.

Profitable securities business traders with MTM owe as much in taxes as a non-MTM trader with the same amount of trading gains assuming no unrealized gains or losses at year-end. Each takes his or her ordinary income tax rate (graduated rates, depending on the level of income) and multiplies it by the amount of trading gains. Cash method short-term capital gains are subject to ordinary income tax rates.

Both MTM and non-MTM traders are able to receive long-term capital gains rate tax relief by segregating investment positions from their trading positions (i.e., keeping them in different accounts is suggested but not necessary). The tax code has historically always had a material difference in ordinary (and short-term capital gains) tax rates versus long-term capital gains tax rates. The 2003 Tax Act widened the difference to 35 percent (ordinary) versus 15 percent (long-term). Both rates may vary and in relation to each other, but the difference is usually a material savings. MTM traders get the benefits of both worlds.

In summary, MTM is the preferred method for securities business traders for four reasons:

1. You don't pay more taxes if you have trading business gains.
2. You benefit greatly if you have losses.

3. You are exempt from the wash sale (straddle and constructive receipt) rules.
4. You still benefit from lower long-term capital gains rates on your segregated investment positions.

Wash Sales

Securities traders and investors are subject to the wash-sale loss-deferral rules. Securities traders using mark-to-market accounting, (§ 475(f)), are exempt from wash sales. Wash sales are a major headache for active traders, because they are difficult to calculate and increase a trader's tax bill. Wash sale losses are not realized in the current tax year, but instead deferred to the next tax year. If you exceed the $3,000 capital loss limitation, wash sales can be desirable. When electing MTM in the following year, wash sales are part of your Section 481 adjustment ordinary loss or part of your realized ordinary loss, which is better than an excess unutilized capital loss.

Commodities and Futures Trading

Commodities and futures are taxed differently from securities. You need to learn about IRC § 1256 contracts, Form 6781, special carrybacks, and how they relate to IRC § 475(f), the new mark-to-market rules.

MTM (IRC § 475) is not a preferred method for profitable commodities and futures business traders for one reason: With the default method, commodities and futures trading gains are 60 percent long-term and 40 percent short-term; MTM (IRC § 475) commodities and futures trading gains are all short term. The current maximum blended tax rate on commodities and futures is 23 percent versus 35 percent on securities, a significant 12 percent difference.

Electing MTM IRC § 475 under these new rules converts your commodities and futures trading capital gains and losses (60/40 treatment) to ordinary gain or loss treatment, a 12 percent tax rate increase.

So, commodity traders face a trade-off. The default method (IRC § 1256—another type of MTM) is better if you have gains.

Section 1256 also has a loss carryback feature; you can carry back commodities and futures trading losses three tax years, but only against commodities and futures trading gains in those years. This loss carryback feature is not as useful as MTM IRC § 475 losses, which are full net operating losses (NOLs) that may offset any type of income in the prior two tax years.

In summary, commodities and futures business traders usually skip electing MTM IRC § 475 because they would increase their taxes on gains and only marginally improve their ability to carry back losses. This result is a stark contrast to securities business traders who get tax loss insurance for no cost (same tax on gains).

Here is one idea: If you incur large commodity trading losses before the election deadline for the current tax year (April 15), elect MTM IRC § 475 so you can deduct your commodity trading losses as ordinary losses. That decision will offset any type of income in the current tax year, and also excess losses can generate refunds in the prior two tax years (regardless whether you have commodities or futures trading gains in prior years).

If you trade both securities and commodities/futures, you may elect MTM IRC § 475 for securities only and not also for commodities and futures—a wise move for many business traders.

If your trading in securities and commodities/futures are unrelated activities (e.g., you trade stocks and also currency and interest futures—rather then securities indexes), the IRS may deem you have separate and unrelated businesses and require you to qualify for trader tax status in each business—meaning you must trade each enough to rise to business treatment.

TABLE OF COMPARISON: TRADERS VERSUS INVESTORS

Table 2.1 points out the numerous benefits for taxpayers using trader tax status and MTM (or even just trader tax status).

Analysis

1. Higher tax rates on short-term (ST) capital gains

2. Lower tax rates on long-term (LT) capital gains

Short-term capital gains (for securities held less than one year) are taxed at a taxpayer's maximum ordinary income tax rates, which vary depending on a taxpayer's income level (graduated tax rates). Long-term capital gains (for securities held longer than one year) are taxed at long-term capital gains rates, which are significantly lower than ordinary income tax rates. For tax year 2004, the maximum long-term capital gains rate is 15 percent; the maximum ordinary income tax rate is 35 percent. This difference represents a huge tax savings, which both investors and traders may benefit from.

Traders qualify for lower long-term capital gains if they segregate their investment positions from their trading positions. This separation can be easily done by holding your investments in an online investment account and conducting your trading in your direct-access brokerage account. Traders really have nothing to lose by gaining trader status; it is extremely rare that a trader would hold a trading position for more than one year. Usually, if that is the case, the position is a loser, or it's a segregated investment position.

As is the norm, Congress makes traders "pay for" tax benefits by offsetting the benefits with limitations and restrictions. Congress makes investors pay for the tax benefit of long-term capital gains rate reduction with the following offsetting restrictions and limitations.

Table 2.1 Comparison of Business Trader vs. Investor

Trader with MTM vs. Without for Securities (not Commodities)	Investors	Business Traders Using Cash Basis Accounting	Business Traders Using Mark-to-Market Accounting
1. Higher tax rates on short-term (ST) capital gains	Yes	Yes	Yes
2. Lower tax rates on long-term (LT) capital gains	Yes	Yes	Yes
3. Limitations on capital losses	Yes Individuals limited to $3,000 net capital loss per year.	Yes Individuals limited to $3,000 net capital loss per year.	No Capital losses are converted to unlimited ordinary losses.
4. Wash sale loss-deferral rules apply	Yes	Yes	No
5. Limitations on investment expenses	Yes	No limitations on business expenses	No limitations on business expenses
6. Limitations on investment interest	Yes	No limitations on business expenses	No limitations on business expenses
7. Qualified traders may use Schedule C for business expenses	No	Yes	Yes
8. Qualified traders may elect mark-to-market accounting	No	Yes	Yes, using MTM
9. Report year-end unrealized gains and losses on trading positions, not investment positions	No	No	Yes
10. Allowed home office and education expenses	No	Yes	Yes
11. Allowed full depreciation on computers and office equipment	Yes (w/limitations)	Yes	Yes
12. Exempt from self-employment taxes	Yes	Yes	Yes
13. Allowed net operating loss carryback refund claims	No	Yes, but only on business expenses	Yes, on business expenses and trading losses

3. Limitations on capital losses

Net capital losses (all capital gains and losses summarized) are limited to a net deduction of $3,000 per year on an individual's tax return; a C-corporation entity tax return cannot deduct any net capital losses. Individual capital losses in excess of the allowable capital loss limitation are carried over to the following tax years, where they may only offset the following year's capital gains. Capital losses may not be carried back to prior tax years.

Traders should watch out for capital loss limitations! If you trade for a living, you are probably risking tens (or hundreds) of thousands of dollars, and it is conceivable that you can end any given year with a trading loss much greater than $3,000, the capital loss limitation amount.

Traders can overcome this limitation. For this reason alone, it is imperative that traders (those that qualify for trader tax status) elect mark-to-market accounting. With MTM, traders' capital losses are converted to ordinary losses, thereby avoiding the capital loss limitation. MTM ordinary trading losses may be used to offset all other types of income on a trader's tax return (spouse's salary, etc.). Traders that incur large trading losses usually have negative taxable income and a net operating loss.

4. Wash sale loss-deferral rules apply

Under the wash sale loss-deferral rules for investors (and traders without MTM), if you sell a stock for a loss and buy it back within thirty days before or after the sale date, the loss cannot be claimed for tax purposes. This rule is designed to prevent taxpayers from selling stock to claim the loss while buying it back within a short period of time to retain ownership. Although a wash sale loss cannot be claimed, the disallowed amount is added to the cost of the new stock. Thus, it can be claimed when it is finally disposed of in a manner other than via wash sale.

Traders Watch Out! Wash sale rules are another compelling reason why investor tax status doesn't make sense for day traders and why Congress changed the tax laws for traders. By nature, day traders trade every day and often focus their trading plan on a few different securities. As a result, it is inevitable that day traders will have multiple occasions of wash sale loss deferrals, which can be extremely complicated to account for. Congress realized that it makes no sense to punish a trader with wash sale violations if that trader has little prospect or desire to hold positions for twelve months or longer to benefit from lower long-term capital gains tax rates.

Traders can overcome this limitation. Qualified traders may elect MTM accounting treatment, thereby becoming exempt from the wash sale loss-deferral rules on their trading accounts. These traders are still subject to wash sale loss rules on their segregated investment accounts.

5. Limitations on investment expenses

Investors are limited in the types of investment expenses they may deduct on their tax returns. Investment expenses are reported as itemized deductions, subject to further limitations from the 2 percent floor for miscellaneous itemized deductions (i.e., these deductions must be more than 2 percent of your adjusted gross income) and the itemized deduction phase out for higher-income taxpayers.

Your itemized deductions will be reduced by the lesser of 3 percent of the excess of adjusted gross income (AGI) above the threshold amount; or 80 percent of the itemized deductions subject to the reduction rules. Investment expenses are also not deductible when computing alternative minimum tax (AMT), a nasty tax that is creeping up on many more taxpayers each year.

Traders Watch Out! By default, direct-access traders are serious traders in the business of trading. Direct-access traders are self-empowered and they use plenty of computers, software, tools, and services to operate their trading business.

Traders can overcome this limitation. Qualified traders are entitled to deduct all their business expenses on Schedule C (Profit or Loss From Business) as ordinary losses.

6. Limitations on investment interest

Investors may deduct investment interest expenses (e.g., margin interest) only to the extent of their net investment income. Any excess investment interest expenses are carried over to the following tax year to be applied in the same manner.

Investment income includes nonqualified dividends and interest earned on your investments, but not income from passive activities (e.g., tax shelter-type investments). Net short-term capital gains from the sale of your holdings are included in investment income. However, net capital gain, defined as the excess of net long-term capital gain over net short-term capital loss, and dividends that qualify for capital gains rates are excluded unless you elect to include some or all of them. Making this election will cost you the lower long-term capital gains rates.

Investment interest expenses are reported as itemized deductions. However, investment interest expenses are *not* subject to the itemized deduction phase-out rules for higher income taxpayers (your itemized deductions will be reduced by the lesser of 3 percent of the excess of AGI above the threshold amount or 80 percent of the itemized deductions subject to the reduction rules).

Traders Watch Out! Many traders use leverage on accounts that have quite a significant balance, which results in many thousands of dollars of margin interest expense. Traders usually do not have much investment income. Compared with investors, they have less chance to deduct their investment interest expenses.

Traders can overcome this limitation. Qualified traders report their margin interest expenses as a business expense instead of as an itemized deduction. Business expenses are not subject to limits.

7. Qualified traders may use Schedule C for business expenses

Qualified traders report their business expenses on Schedule C (Profit or Loss From Business). These expenses include but are not limited to margin interest expenses; depreciation on computers and equipment; amortization on software; Internet service; chat room services; training, supplies, postage, and couriers; phone; online and print research; travel; entertainment; gifts; business accessories; and home office expenses.

8. Qualified traders may elect mark-to-market accounting

Mark-to-market (MTM) accounting treatment for traders is the crux of the trader tax laws. A trader using MTM accounting will implicitly close out all open trading positions (open long positions and short sales) using the market value on the last trading day of the year. These MTM traders report both realized and unrealized trading gains and losses as ordinary gains and losses rather than capital gains and losses, which are limited.

The reason traders should use MTM is because their losses are treated as ordinary rather than capital. MTM traders pay the same ordinary income tax rates on securities trading gains as traders and investors using the cash method.

Traders in securities are similar to traders in commodities—both buy and sell frequently to make money on quick changes in market price. A different type of MTM is the required method of accounting for trading in commodities (per the Tax Act of 1986). IRC 1256 MTM has capital loss treatment unlike IRC 475(f) MTM, which has ordinary loss treatment. Congress required commodity brokers to report commodity trading gains and losses to traders using the MTM method because they wanted to close loopholes in the tax law being abused by commodity traders (e.g., straddles, loss deferrals, etc.). Congress considers MTM the proper accounting method for traders because it is based on the economic reality. Congress also realized that day trading involves thousands of transactions and that it would be difficult for the IRS to audit a trader's tax return using the cash basis, but much easier to audit the tax return of a trader using MTM.

9. Report year-end unrealized gains and losses on trading positions, not investment positions

The reason traders should use MTM IRC 475(f)is because their losses are treated as ordinary rather than capital. Their potential for unrealized gains or losses on trading positions is not material, because active traders normally close out trading positions by the end of each day. Swing traders normally close out trading positions before year-end.

All MTM traders may still segregate investment positions. Traders may not use MTM on investment positions, so traders who have large unrealized gains on long-term investment positions do not report these unrealized gains on their tax returns until the year these investments are actually sold.

10. Allowed home office and education expenses

Most business traders convert one or more rooms in their home to an office and use it exclusively for their trading business. With the new, more liberal home office deduction rules, most traders can receive a tax benefit of more than $5,000 per year just on this one deduction. Investors are not allowed to deduct home office expenses, even if they use a room exclusively for investing activities.

Investors may not deduct education expenses, but traders in business may. Pretrading business education expenses may be included in IRC § 195, Start-Up Expenses, if they are for investigating and inquiring about a trading business. (More information on education expenses is provided later in the book.)

11. Allowed full depreciation on computers and office equipment

Most business traders use computers and other office equipment to operate their trading business. Traders may fully depreciate the cost of their computers and equipment, whereas investors are subject to the listed property rules using straight-line depreciation. These rules say that any computers and office equipment used for investment activities can only be depreciated if they are predominately used (i.e., used more than 50 percent of the time) for investing activities. Many investors also use their computers for personal use (entertainment, general news, taxes, etc.). The IRS frowns on these deductions for investors, but welcomes them for traders. Business traders may also use IRC § 179, the 100 percent depreciation rules, providing they have trading gains —otherwise this depreciation deduction is carried forward. Business traders may also use accelerated and bonus first year depreciation methods.

12. Exempt from self-employment taxes

Traders in securities and commodities using the cash or MTM methods of accounting are exempt from self-employment (SE) taxation. A trader qualifies as "being in the business of trading," which normally requires that SE taxes apply. However, Congress passed a special exemption for traders from the SE tax in the 1998 Tax Act. One exception, a commodities dealer or trader registered on a commodities exchange does owe SE taxes (IRC § 1402 (i)).

13. Allowed net operating loss carryback refund claims

Net operating losses (NOL) are usually comprised of a trader's business expenses and ordinary trading losses from using MTM accounting.

Traders may file amended tax returns or a preferred Form 1045 (quickie refund claim) carrying back their NOLs to their two prior tax return years. The NOL offsets taxable income in those prior tax years and reduces the tax liability accordingly. The decrease in tax liability then becomes an immediate refund claim.

Rather than carrying back a NOL, a taxpayer may elect to forgo the NOL carryback and instead carry it forward (to be applied against all and any ordinary, capital, or other type of income in the following tax year for up to twenty years).

Even traders not using MTM may have a NOL caused by their trading business expenses.

NOLs

Business taxpayers are allowed a special huge tax benefit through net operating loss (NOL) tax laws. These laws provide the opportunity to carry back and/or forward business losses. Make a fortune in one year and pay your taxes, then lose a fortune in the following years and carry back your NOLs to get huge refunds of taxes paid in the prior (profitable) years. If this sounds too good to be true, it isn't.

In 2001, Congress passed temporary relief extending the carryback period from two to five years for 2001 and 2002 NOLs. This news was fantastic for traders, because most traders made a fortune in 1997, 1998, and 1999 and then lost a fortune in 2000, 2001, and 2002. For example, a trader can carry back a 2001 NOL to 1996 through 2000, instead of just carrying it back to 1999 and 2000 (which was the previous law). This tax law change has great significance for traders, because many already carried back 2000 losses to 1998 and 1999 and already used up the gains for those years. In summary, this tax law change put hundreds of thousands of dollars in the pockets of many traders. Unfortunately, Congress failed in its attempt to extend the five-year NOL carryback period beyond 2002, so only two-year NOL carrybacks apply afterwards.

Our firm has many trader clients and we have prepared hundreds of net operating loss tax returns over the past few years. Our clients received their refunds, even in those cases where the IRS asked some questions. In a few cases, the refunds are delayed. NOL refund claim tax returns are complex and require exact execution. Otherwise, they can lead to questions from the IRS.

The IRS discusses NOLs on its website at www.irs.gov/publications/p536/index.html. IRS Publication 536 provides information on how to claim an NOL deduction.

The following excerpts come from Robert A. Green's article in the September 2002 issue of *Active Trader* magazine.

Net Operating Losses (NOLs)

> A trader who qualifies as being in the business of trading (trader tax status) has ordinary losses from trading business expenses. If that trader elected MTM on time, they also have ordinary loss treatment on trading losses. If that trader has negative taxable income, because their

> trading losses and expenses exceed their other income, then that trader most likely has a Net Operating Loss (NOL).
>
> Taxpayers may carry back 2001 and 2002 NOLs two or five tax years, or they may elect to forgo a carryback to instead carry their NOL forward to future tax years (twenty years).
>
> The 2002 Tax Act provides temporary relief: the normal two-year carryback period is changed to two or five years back for 2001 and 2002 NOLs only, and Alternative Minimum Tax rules are relaxed in connection with NOLs. These new rules are boon for traders, since many traders have significant taxable income in years prior to 2000; allowing a better opportunity to utilize NOLs for tax savings.
>
> An NOL carryback has the consequence of amending a tax return for prior tax years. The NOL is a new tax deduction for that amended tax year and the NOL deduction may be applied against taxable income of any kind in that year, whether or not the trader qualified as a trader in that prior tax year.
>
> NOL tax returns may be filed on Form 1045 (Application for Tentative Refund) within one year of filing your current year tax return that generates the NOL. Alternatively, you may file your NOL return on a Form 1040X (Amended US Individual Income Tax Return) within three years of filing your current year's tax return. Form 1045s are filed faster than Form 1040X, so you get your refunds faster. Form 1040X returns are more scrutinized. Both returns for trader NOLs are very complex and you should engage a proven trader tax CPA firm for help. One error on these returns often results in IRS questions, or an exam or delayed refunds.

The article also gave an example of how a trader could save significant money with NOLs by using an actual return prepared by our firm.

Joe Trader has a job as a full-time consultant for a high-tech company. Joe also qualifies as a part-time securities trader for 2001. Joe elected mark-to-market (MTM) accounting on time, by attaching an election for IRC § 475(f) to his 2000 federal tax extension, filed by April 15, 2001.We reported Joe's 2001 trading business expenses on Schedule C (Profit or

Loss From Business). The net Schedule C loss of ($3,428) is reported on Form 1040 page 1, line 12. This loss is not limited in any way.

We reported Joe's MTM securities trading losses on Form 4797 (Sale of Business Property), part II Ordinary Gains and Losses. The Form 4797 loss of ($1,613,068) is reported on Form 1040 page 1, line 14. This loss is not limited in any way.

Joe elected MTM for 2001, and he had trading positions open at the end of 2000. We calculated Joe's IRC § 481(a) adjustment as negative ($22,050). On Joe's Form 4797 (Federal Statement), we report the entire IRC § 481(a) adjustment loss of $22,050.

Joe's Form on 1040 page 2 shows a negative taxable income of ($1,518,050) on line 37 before exemptions. Joe's trading losses and business expenses fully offset all of Joe's other income, of any kind.

On Form 1045 and the Election statement, Joe elected to forgo the five-year carryback (from the 2002 Tax Act changes), and we carried his 2001 NOL back two years to 1999 and 2000 (because he did not utilize the NOL fully in 1999).

Joe received a 2001 tax refund on Form 1040 page 2 in the amount of $9,457. Had Joe not elected MTM, he would have owed $6,614, an increase in tax versus using MTM in the amount of $16,071. With the cash method, Joe would have a capital loss limitation of $3,000, so his large trading losses would not offset his other income.

With MTM, Joe had a significant 2001 NOL, and he received tax refunds on his Form 1045 as follows: $186,506 for 1999; and $385,034 for 2000.

Joe also received interest from the IRS on his tax refunds, because these changes in tax liabilities are for prior tax years. Joe's total refund checks come close to $600,000.

Joe already received his tax refund checks, and he used them to replenish his otherwise depleted trading accounts. Joe is thrilled he elected MTM on time.

Notes About Form 1045: The 2002 Tax Act adds a five-year NOL carryback choice to the existing two-year carryback law. This temporary change only applies to NOLs generated in 2001 and 2002; the rule reverts to only the two-year carryback period starting again in 2003. The IRS planned a revised Form 1045 for late summer 2002 release to reflect the new five-year carryback choice.

A complex area for NOL returns is the alternative minimum tax (AMT). The 2002 Tax Act temporarily changed the AMT NOL from 90 percent to 100 percent for 2001 and 2002 NOL returns only. This good news for traders means with 100-percent AMT NOL, the nasty AMT tax won't reduce a trader's NOL refund claim. AMT is a second set of tax calculations that differs from regular tax calculations; the ones you focus on most. AMT has nasty surprises for many taxpayers, not allowing certain deductions for AMT taxable income and requiring other adjustments, all of which can increase your tax liability.

NOL carryback tax returns are complex in cases where a taxpayer had a different filing status in the NOL carryback years.

The Bottom Line: Taxpayers in the securities trading business should use trader tax status (Schedule C) and mark-to-market accounting (Form 4797). With this trader tax status, profitable traders maximize their tax savings (using ordinary business deductions), and losing traders have ordinary losses that often times generate a net operating loss (NOL).

NOL refund claims are great news for traders. NOL refunds are often the last resort for replenishing a trader's working capital. However, NOL tax returns are complex and often scrutinized by the IRS. One small error or omission can cause an IRS exam or significantly delay your NOL refunds. It is highly recommended that you consult with a proven trader tax professional experienced with NOL returns.

CHAPTER SUMMARY

MTM is a powerful weapon in delivering maximum tax benefits to traders. It helps allow traders to claim NOL deductions, which can be huge. Remember, though, a taxpayer is not eligible to elect MTM unless he first qualifies for trader tax status, and MTM must be elected on time, by April 15 of the current tax year. Failure to do so can cost traders thousands of dollars in lost refunds.