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Recent tax court case focused on trader tax status and mark to market accounting.

Here is the news and GTT's take on it. Don't panic, this case does not change anything and you can rely on all advice for trader tax status and MTM elections in our guides and services. Here are some quick observations along with the news and we will update this with more in-depth analysis and observations shortly.

**The news:** The below tax court case Chen vs IRS has spooked many traders, who are worried about also having trouble from the IRS because they filed as part time, or part year traders or even as individual sole proprietor traders. This is an excellent time to revisit many issues surrounding trader tax status.

## **GreenTraderTax and GreenTraderLaw observations:**

### **Would an entity have helped Chen?**

Some CPAs and attorneys may draw the wrong conclusions from the Chen case; specifically that had Chen had an entity, he would have won his trader tax status position and possibly even MTM.

Some tax attorneys advocate forming an entity to perfect "trader tax status" and (better) elect mark to market accounting (MTM) IRC 475. These attorneys point out that an entity is by default presumed to be a business entity (with business treatment – which means trader tax status for a trader. Our firm refutes these arguments and firmly believes that any trading company must pass the same trading activity tests - to rise to the level of trader tax status. We have discussed this with some of these attorneys and they concede that if an entity's trading activity does not rise to the level of trader tax status, then the entity will be treated as an "investment company" (with investor tax status). Investor status renders a MTM election null and void. For more information on trading versus business entities, see Robert Green's article here. <http://www.greencompany.com/HedgeFunds/OffDocGTTTaxStrategies.shtml>. The "presumption" of business treatment carries no weight with the IRS in terms of allowing trader tax status (business expense and MTM ordinary loss treatment), so these attorney arguments carry little weight in our book.

Bottom line, an entity would not have helped Chen win his case on trader tax status. It may have been easier for Chen to win his argument on a MTM election, since a new entity is a "new taxpayer" who may elect MTM "internally" (in their own books and records), rather than "externally", by filing an election statement with the IRS by 4/15/xx of year xx. MTM elections also require a Form 3115 filing by the extended due date (not late) with the tax return of year xx.

IRC 475, the mark to market regulations are specifically written to provide a formal method for individuals to elect MTM. MTM requires trader tax status as a pre-requisite, so this proves the IRS intended MTM for individuals with sole proprietor trader tax status. This is another reason why individual business traders don't need entities. GTT does recommend entities for retirement plan and health insurance premium deductions (from AGI) and for late year MTM elections. Learn more here <http://www.greencompany.com/Traders/TraderEntities.shtml>.

Our firm has filed thousands of individual sole proprietor business trader tax returns using MTM and many reported large MTM ordinary losses and got huge refunds, with much bigger numbers than in the Chen case. Hundreds of our trader tax returns filed were for part time, part year and money losing traders and they all received large refunds with IRS questions or exams. We also filed many Net

Operating Loss (NOL) returns which are much riskier, some with hundred thousand plus refunds and had no problems.

In the few cases, we heard from the IRS, we answered their questions quickly to their satisfaction and there was no exam. We also won several exams on this point quickly and easily.

So Chen is not about trader tax status and MTM for individuals and any attorney promising a panacea with an entity is promising a myth. It simply comes down to having trader tax status as an individual or an entity and properly and timely electing MTM.

Chen did neither, he did not prove his trader tax status and he never elected MTM properly and tried to cheat the IRS on MTM.

**Chen's case was lost because he allowed the IRS to consider him a "sporadic trader" and because the IRS perpetuated a myth that trading must be your primary source of income.**

Based on the way Chen presented his case and dealt with the IRS, we agreed he should have lost. We would have presented his case differently (assuming his facts would bear us out) and we may have won this case.

First, Chen started off on the wrong foot by trying to cheat the IRS on a phony and/or late MTM election and claiming he could use it "retroactively." Wrong on all accounts as clearly written in the law; the MTM laws are formal and very clear.

Second, Chen never rebutted the IRS arguments about sporadic trading and primary source of income rules. The IRS wrongly applied the "sporadic trading" argument and the 'primary source of income rule' is a fallacy, not in the law and wrong applied in logic anyway to traders – so it's wrong on all accounts.

Chen should have engaged a firm like ours and we could have possibly won this case for him. Never be your own advocate with the IRS, they will eat you alive. Had the IRS dealt with our firm during the case and in appeals as the next step, an appeals officer would doubtfully have brought this case to Tax Court (and settled with us beforehand), because our firm would not let them get away with misapplication of the sporadic trading argument and the false primary source of income rule.

The IRS could have easily won this case on the late MTM election, but chose to set a precedent on the sporadic trading and primary source of income rule.

Remember, trader tax status is not statutory law and it's based on case law. The rules are not clearly explained in the law so tax court judges must assemble a body of law based on individual cases. Chen hurt all traders by trying to save a buck and not hire proper legal counsel. He should have hired GreenTraderLaw – our tax attorneys could have prevented this bad case precedent for the benefit of all traders. Join our GTT Alliance for Traders to help prevent this in the future – our alliance can take on these types of cases for little cost to a taxpayer, if our alliance is funding it. Learn more and join here <http://www.greencompany.com/Traders/Advocacy.shtml>.

**Chen could have won on the sporadic trading issue.**

If Chen could have shown his intention was to leave his job and be a fulltime and profitable business trader, along with other positive factors presented, he might have won this case on the trader tax status issue (but of course lost on the MTM issue as he was clearly late).

Other key factors he could have shown - which may not be his actual factors, but others can use in their cases - are that he lost all his available capital within the 3 month period and he was therefore forced to exit the trading business (it takes money to lose money).

Compare this concept to majority of other business start up situations. Consider the example of a software engineer that develops his own software product on the side from his day time job. He invests lots of money and time into the product; sets up a Web site; arranges for resellers; starts selling some product; and after 3 months, clients complain of major bugs and sue him for much more than his investment. Rather than hire attorneys to deal with these problems he simply exits the business after 3 months. The engineer clearly set up a business and is entitled to a Form 4797 ordinary business loss on his \$75,000 investment. How is this any different from having a trading business over a 3 month period? The fact is that most start ups fail in less than a full calendar year's time – hence they are part year and often part time businesses.

The IRS is prejudice against part time, part year and money losing traders. In our 2004 GTT Trader Tax Guides, we have a separate chapter each for part time, part year and money losing traders. We explain how to take these positions, how to report them on your tax returns (with clear examples) and how to deal with the IRS if they ask questions or you have an IRS exam. Learn more here.  
<http://www.greencompany.com/Traders/Guides.shtml>.

The IRS have risen the “sporadic trading” argument as a problem in several exams our firm has been involved with (and our firm won). We do agree that sporadic trading is a valid argument and it can be used successfully by the IRS in some cases to deny a taxpayer trader tax status.

Correct application of the sporadic trading argument would be reasonable in the following scenario. A retired stock broker plays golf half the week and trades for his own account the other half. He travels often with his wife and does not trade during those times. He trades hyperactively for a few days and then has no trades at all for weeks or months at a time. He has sporadic trading and his trader tax status is at risk, even if he has 1,000 trades for the year. He may trade “frequently” but not “regularly and “continuously” – all three are required for trader tax status.

Chen did not have sporadic trading; he had hyperactive frequent, regular and continuous trading until being forced out of the trading business with losses. Chen was a part year, part time and money losing trader – a triple whammy of problems in the IRS view.

Chen had enough trades per year, if one counts those trades on an annualized basis (1,200). Trader tax status cases have been won with similar actual numbers of total trades for an entire year (300+). So Chen's number of trades should not be an issue.

Had Chen show that he did not have sporadic trading, based on the arguments we raise above, we believe Chen could have won this case on trader tax status only (he clearly would lose the MTM part of the case).

Here are some ways to trump an IRS argument about sporadic trading. Explain that you may have been still spending 40+ hours per week in the trading business, but just not executing trades and explain why not. Perhaps, you were short capital, or your trading program did not trigger trading opportunities, or you had to take off some time for personal, medical or other family reasons, or other activities. The IRS focuses on trades only, but there are lots more to a trading business than just numbers of trades. Like any business trader, you need to show your business intent, document the seriousness of your business plan, keep and show your diary and more. Our firm can help here.

**The IRS says trading must be your primary source of income – that is false and a myth.**

The IRS snuck a concept into the Chen case that we have seen before on their Web site, but not in any official publications or statutory law – the ‘primary source of income’ rule.

Chen should have challenged application of this alleged rule. We are certain that trading does not have to be your primary source of income to be a valid business.

Consider this scenario. What happens if you have a small part time job or business, to keep your hands in your old profession and pay some bills just in case you lose money trading, but spend the great majority of your week in a hyperactive trading business with tens of thousands of day trades? Clearly, you met the requirements of trader tax status on all accounts, but let's see how the primary source of income (fallacy) rule can play havoc on your potential IRS exam case.

Assume, you lose \$500,000 in your trading business and make \$25,000 in your part time job. Using the IRS rule, as they presented it in the Chen case and on their "unofficial" Web site information, this scenario could lead to disallowance of trader tax status and MTM ordinary loss treatment on this \$500,000 trading loss. That is outrageous and inappropriate. Here is why. Note, only IRS publications, forms and regulations are "official" and this primary source of income rule does not appear anywhere in the official IRS body of law.

By default, a very active trading business can generate huge gains or losses in any given year, and a trader may never generate net gains. That is clearly the nature of the business and study after study shows that the majority of traders have losses.

In 1997, Congress passed the MTM regulations IRC 475(f) specifically to provide relief to the growing ranks of online traders, so traders could have ordinary loss relief. Congress figured a trader might make huge gains in one year and if they lost huge amounts in the following year, with MTM, they would have a NOL that could be carried back, to in effect average out their taxes. Congress recognized that traders would be unduly punished by the puny capital loss limitations of \$3,000 per year on individuals.

Congress did not intend the IRS to override their legislation by apply this faulty argument on the primary source of income rule. Here is how the IRS can abuse this rule. The first year, the IRS gladly receives the taxes paid on huge gains, but in the second year the IRS says, since you have a puny job on the side and you lost money trading, it's not your primary source of income and you can't deduct an MTM ordinary loss or business expenses. That is ridiculous and here is why.

In the first case, the primary source of income rule is not in the tax law and can't be applied to – and never is applied to – any other business. Lot's of business people have multi businesses and they never face this type of faulty reasoning and attempted rule making.

In the second case, assume in this IRS make believe world such a rule did exist, we argue it could never be appropriately applied to a trading business. Unlike other businesses, which may have consistent profits from year to year, like a CPA firm, law firm, manufacturer, retail store etc, by its nature a trading business is most likely to have gains in some years and losses in other years, and some always have losses.

Primary source of income implies that one activity, business or job is primary and others are secondary. Since when does only a top money making business get business treatment and all other businesses get relished to the ranks of "investment status"?

It is unconstitutionally prejudicial by the IRS to allow business treatment only on gains and investment status on losses. That is contempt to Congress who directs the IRS to codify their rules, not to subvert them. This is strong language on my part, but I am upset by the IRS trying to perpetuate this faulty argument which is clearly outside the law.

Read the summary of the Chen case by RIA below.

If you have any questions about the Chen case or if you have an IRS exam, we strongly suggest you

contact us sooner than later. Read about our leading IRS Exam services here.

<http://www.greencompany.com/Traders/TraderIRSExams.shtml>.

**Here is the Chen case with observations from RIA: I highlighted some key points.**


**Frequent but sporadic securities trading results in investor status and capital losses:** A recent Tax Court case illustrates **how difficult it is for a stock market investor to show that his activities rise to the level of a trade or business. Over 300 trades by a software engineer weren't enough to justify trader treatment because they took place in a limited period of time.** As a result, the Tax Court **didn't have to consider whether his late mark-to-market election was effective.**

**Frequent but sporadic securities trading results in investor status and capital losses**

**Frank Chen v. Comm., [TC Memo 2004-132](#)**

A recent Tax Court case illustrates how difficult it is for a stock market investor to show that his activities rise to the level of a trade or business. Over 300 trades by a software engineer weren't enough to justify trader treatment because they took place in a limited period of time. As a result, the Tax Court didn't have to consider whether his late mark-to-market election was effective.

*Investors vs. traders.* Stock market investors, regardless of how frequent they trade, have sales that generate capital gain or loss. However, persons engaged in the trade or business of trading securities may elect to have the [Code Sec. 475\(f\)](#) mark-to-market (MTM) rules apply. Under these rules: (1) gain or loss is recognized on these securities held at the close of any tax year as if they were sold for their fair market value on the last business day of the tax year; and (2) gain or loss is taken into account for the tax year as ordinary income or loss. ([Code Sec. 475\(f\)\(1\)\(A\)](#); [Code Sec. 475\(d\)\(3\)](#))

 **RIA observation:** A taxpayer with stock losses often would prefer to be a trader in securities (rather than an investor) in order to bypass the capital loss limitation rules that allow capital losses in excess of capital gains to offset no more than \$3,000 (\$1,500 in the case of married individuals filing separate returns) of ordinary income each year. By contrast, losses of an electing trader in securities incurred in the ordinary course of business generally are not subject to these limitations and may be deducted in full against ordinary income.


Whether a taxpayer's investment activities rise to the level of carrying on a trade or business is based on, among other things, the taxpayer's investment intent; the nature of income to be derived from the activity; and the frequency, extent, and regularity of the taxpayer's securities transactions. (Moller v. U.S., (CA Fed 11/18/1983) 721 F.2d 810 [52 AFTR 2d 83-6333](#)).

*Facts.* During '99, Frank Chen, a full-time engineer, incurred a net loss of \$84,794 in connection with 323 transactions involving the purchase or sale of securities, **most of which he**

**held for less than 1 month.** Approximately **94% of those transactions occurred in Feb., Mar. and April of '99.** Chen made these trades through two brokerage accounts and used software that provided him with up-to-the-minute information on securities.

In Oct. 2001, IRS issued a notice of deficiency to Chen for '99. He didn't timely file for the year but included with a Tax Court petition challenging the deficiency a copy of a return for '99. This return also included a purportedly retroactive [Code Sec. 475\(f\)](#) election, dated Mar. 9, 2003, to use the MTM method of accounting effective Jan. 1, '99. IRS argued that he was not a trader in securities, but merely an investor. Thus his losses were not deductible in full but were capital losses limited to the extent of \$3,000. IRS claimed that even if Chen were a trader in securities, his retroactive MTM election was not effective because it was untimely. **Chen argued that because of the volume and short-term nature of his '99 trades, the time devoted daily to his trading activities, and his substantial investment in software, he qualified as a trader in securities.** He also claimed that his retroactive MTM election was effective.

*Taxpayer was not a trader in securities; losses were capital.* The Tax Court held that Chen was not a trader in securities, but rather an investor. Thus, his losses incurred were not fully deductible ordinary losses, but were capital, subject to the loss limitation rules. **The Tax Court conceded that Chen did buy and sell securities with frequency. However, the Court emphasized that most of his daily trades were conducted for only a quarter of the year and thus were not “frequent, regular, and continuous” but sporadic.** In addition, throughout '99 Chen maintained a full-time job as a computer chip engineer and trading was not his primary source of income. The Tax Court said there was no need to address the issue of whether Chen's MTM election was effective, because he did not qualify as a securities trader.

 **RIA observation:** Even if Chen had qualified as a trader in securities, IRS would have denied his late MTM election. In an IRS technical advice memo issued as [PLR 200423015](#), IRS recently reiterated its position that to be effective, an MTM election must be made by a trader's unextended return due date for the tax year immediately preceding the election year.

**References:** For rules on trader in securities versus investor status, see FTC 2d/FIN ¶ L-1112 ; United States Tax Reporter ¶ 280A4.013 ; [TaxDesk ¶ 256,010](#) ; For the mark-to-market rules for electing securities traders, see FTC 2d/FIN ¶ G-2114.1 ; United States Tax Reporter ¶ 4754.01 .

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