Taxing Investors on a Mark-to-Market Basis

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TAXING INVESTORS ON A MARK-TO-MARKET BASIS

Samuel D. Brunson*

Recognizing that mark-to-market accounting, with its close approximation of Haig-Simons income, represents a better measure of a taxpayer's income than realization accounting—the historical basis for the federal income tax—Congress enacted section 475(f) of the Internal Revenue Code. This section permits certain taxpayers to elect out of the realization accounting regime and instead mark their investments to market. Congress limited the availability of this election to taxpayers who were engaged in the trade or business of trading securities. Although the election must be made early in a taxpayer's taxable year, the test for determining whether a taxpayer is engaged in the trade or business of trading securities during a taxable year can only be performed after the year ends. As the rules for making a mark-to-market election are currently written, in order to determine whether she qualifies to make the election, a taxpayer must know no later than April 15 what the extent of her trading activities will be for the rest of the year, as well as for all future years. There is no compelling tax policy reason to limit the availability of the mark-to-market election. Rather, the superiority of mark-to-market accounting over the current realization regime supports a policy of allowing (and encouraging) taxpayers to determine their tax liability on a mark-to-market basis and outweighs any objections to liberalizing the election's availability. Alternatively, in the event that Congress decides that denying non-traders the ability to elect mark-to-market treatment is justified, Congress or the Treasury Department should adopt a proposed safe-harbor provision that approximates the criteria courts consider when determining whether a taxpayer is a trader, but that, unlike the current trade-or-business test, can be applied in advance of the taxable year. Although providing a safe harbor solely to traders is, from a policy perspective, worse than making the mark-to-market election available to all taxpayers, it is nonetheless better than the current unworkable criteria because it provides certainty to taxpayers at the time they must make the election.

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# Table of Contents

I. **Introduction** ................................................................................. 509

II. **Mark-to-Market Accounting Reflects Haig-Simons Income** ................................................................. 512

III. **Trade or Business** ........................................................................ 517

   Uses of "Trade or Business" in the Code .................................................. 518

IV. **Trade or Business for Purposes of the Mark-to-Market Election** ................................................................. 523

V. **Why the Judicial Trade-or-Business Criteria Do Not Work** ........................................................................ 527

VI. **A New Regime for Mark-to-Market Elections** ......................... 531

   A. Eliminating the Mismatch ................................................................. 531

   B. The Safe Harbor ............................................................................ 535

   C. Enactment of the Safe Harbor Through Regulatory Means .............. 539

   D. Enactment of the Safe Harbor Through Legislative Means ............... 544

VII. **Conclusion** .................................................................................. 547
I. INTRODUCTION

As a result of the recent implosion of mortgage-backed securities and the subsequent debate over banks’ balance sheets, many Americans probably have some familiarity with mark-to-market accounting, even if such familiarity is limited solely to having heard the words strung together. Still, many people are aware that, until recently, banks were required to mark their assets to market (whatever that means) and that this requirement could (depending on whom one believes) lead to the collapse of the remaining banks.

In the wake of the banking system’s near collapse, little if any time has been spent looking at mark-to-market accounting for tax purposes, as opposed to financial accounting purposes—and perhaps with good reason. Except when they facilitate fraud or catastrophe, methods of accounting do not grip the public imagination. In any event, tax accounting is essentially a settled matter. Realization accounting—an accounting standard that does not require taxpayers to pay tax on income until the year in which they receive the income—is (and historically has been) the default position of the

1. E.g., Edmund L. Andrews, Battles over Reform Plan Lie Ahead, N.Y. TIMES, Mar. 27, 2009, at B1 (“Edward L. Yingling, president of the American Bankers Association, said he hoped to use the meeting with Mr. Obama to make the case for relaxing mark-to-market rules, which require financial institutions to value their investment securities at current market prices. Banks have argued that the rules are hurting their financial positions.”); Massimo Calabresi, Will a Mark-to-Market Fix Save the Banks?, TIME, Mar. 11, 2009, http://www.time.com/time/business/article/0,8599,1884290,00.html; David Hendricks, Congress Hijacked Accounting Standards, SAN ANTONIO EXPRESS-NEWS, Apr. 18, 2009, at 1C (“Some members of Congress think the banking system is suffering under a rule called mark-to-market.”); Michael Hiltzik, Rule Is No Asset to Banks’ Health, L.A. TIMES, Mar. 23, 2009, at B5 (“This brings us to the concept of ‘mark-to-market’ accounting. If you haven’t heard this term before, brace yourself, because you’ll be hearing it a lot over the next month or so.”); Steve Forbes, How Steve Forbes Would Fix the Economy, FORBES.COM, Feb. 2, 2009, http://www.forbes.com/2009/01/30/fannie-freddie-mortgages-davos-intelligent-investing_0202_davos.html (“[O]ne of the things that the Obama administration could get rid of is this strange accounting rule called mark-to-market, which has devastated bank balance sheets.”). While it is beyond the scope of this Article to determine whether mark-to-market financial accounting is detrimental to banks, it is necessary to note that it is not a foregone conclusion that mark-to-market accounting dragged down the U.S. economy. E.g., Allan Sloan, Playing the Blame Game: Will Mark-to-Market Accounting Take the Fall for the Wall Street Mess?, FORTUNE, Oct. 27, 2008, at 20 (arguing that mark-to-market accounting is being used by banks as a scapegoat for the banks’ poor investment decisions); Jonathon Weil, Don’t Blame “Mark to Market” for Banks’ Problems, BLOOMBERG.COM, Mar. 17, 2008, http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=UFrPa3rqHw (debunking misinformation about mark-to-market accounting’s effect on banks).
U.S. tax system. Still, it is at most a second-best solution to the question of when income should be taxed. The literature on tax theory widely supports the notion that a mark-to-market system of taxation “best measures Haig-Simons accretion to wealth and therefore is the optimal method to tax income.” In spite of the theoretical superiority of mark-to-market accounting, this form of accounting is unlikely to supplant realization accounting.

Still, over the course of the last quarter century, Congress has slowly introduced mark-to-market accounting into the taxation of financial instruments and other investments, first by requiring taxpayers to mark regulated futures, foreign currency, and certain other contracts to market, and then by requiring dealers in securities to mark their securities to market. In addition, dealers in commodities and traders in securities or commodities may now elect to mark their positions to market.

4. See Thomas L. Evans, The Realization Doctrine After Cottage Savings, 70 TAXES 897, 898 (1992) (“[A]n attempt to repeal the realization doctrine on a wholesale basis for individual taxpayers would create such a firestorm of political opposition that few politicians would seriously consider such a proposal.”).
7. I.R.C. § 475(e)–(f).
However, Congress stopped with traders, creating a significant practical problem for taxpayers wishing to make the election: while the boundary between a trader and an investor has been extensively developed,\(^8\) it is worthless to a taxpayer who wants to elect mark-to-market taxation. The test applies ex post facto, requiring a taxpayer to look at the extent of her trading over the previous year to determine whether she was a trader or an investor during that year.\(^9\) This prevents taxpayers from using the mark-to-market election strategically because the election must be made long before the taxable year ends and thus before the taxpayer can determine whether she was a trader.

Moreover, it is unclear why investors should be prevented from electing to be taxed on a mark-to-market basis. Congress did not explain why it limited the election’s availability, and in light of the theoretical superiority and elective nature of mark-to-market accounting, there is no policy reason to permit traders in securities to mark their securities to market while limiting investors to realization accounting.

This Article proposes an overhaul of the mark-to-market election and offers three possible fixes to the problems inherent in the current regime. As a best-case solution, this Article proposes expanding the mark-to-market election to investors, thus mooting the problem of determining ex ante whether a taxpayer qualifies as a trader in securities. In the alternative, if Congress decides for policy or other reasons that it prefers to limit the availability of the election to traders, continuing to exclude investors, this Article proposes that Congress enact an ex ante qualification test to replace the current ex post trader test. Finally, if Congress decides to do nothing, this Article proposes that the U.S. Department of the Treasury issue regulations creating an ex ante safe harbor. Although the regulatory solution is the least ambitious, at the very least it would allow taxpayers certainty in making the mark-to-market election.

In Part II, this Article describes the theoretical underpinnings of mark-to-market accounting and some reasons a taxpayer would make the election. Part III describes the use of “trade or business” in the Internal Revenue Code (the “Code”) and the criteria that distinguish

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8. See Moller v. United States, 721 F.2d 810, 813 (Fed. Cir. 1983).
a trader from an investor. Part IV discusses recent cases in which courts have applied the broader trade-or-business jurisprudence to an election under section 475(f) of the Code. Part V discusses the problems with the judicial test for a trade or business in general, and the problems with its application in the context of late mark-to-market elections in particular. Finally, Part VI presents proposals for improving the mark-to-market election.

II. MARK-TO-MARKET ACCOUNTING REFLECTS HAIG-SIMONS INCOME

If a taxpayer is subject to mark-to-market accounting, she treats all of the securities she owns at the end of each taxable year as if she had sold them at fair market value.\(^\text{10}\) Although realization accounting is "firmly entrenched" in the federal income tax,\(^\text{11}\) in 1993, Congress passed section 475, which requires dealers in securities to mark the securities they hold in their capacities as dealers to market.\(^\text{12}\) Congress decided that, under section 475, gains or losses are taken into account as ordinary income or loss for the year, except to the extent that the gains or losses occur on securities contracts governed by section 1256.\(^\text{13}\)

Mark-to-market accounting is a significant departure from the realization accounting generally applied to calculate federal income tax liability. Because it comes closer to taxing Haig-Simons income\(^\text{14}\)

\(^{10}\) I.R.C. § 475(a).


\(^{13}\) I.R.C. § 475(d)(3)(A)(i). I.R.C. § 1256 governs certain futures contracts and options. Any contract governed by I.R.C. § 1256 is marked to market annually, absent any election, I.R.C. § 1256(b), with 40 percent of any gains or losses treated as short-term capital gain and 60 percent as long-term capital gain, I.R.C. § 1256(a)(3). For purposes of I.R.C. § 475, the term "security" includes derivative contracts on securities, but expressly leaves out contracts to which section 1256(a) applies. Id. § 475(c)(2). A securities trader who elects mark-to-market accounting can therefore continue to mark her section 1256 contracts to market and recognize capital, rather than ordinary, gain or loss on those positions. The definition of "commodity," however, does not mention section 1256 contracts, see id. § 475(e)(2), and the Treasury Department takes the position that an electing commodity dealer or trader must take into account annually the change in value of her section 1256 contracts on commodities as ordinary (not capital) income or loss. Prop. Treas. Reg. § 1.475(f)-2(e)(2), 64 Fed. Reg. 4374, 4374 (Jan. 28, 1999).

\(^{14}\) The Haig-Simons definition of income "is now the generally accepted definition of income on which virtually all income tax theory is predicated." William J. Turnier, Theory Meets Reality: The Case of the Double Tax on Material Capital, 27 VA. TAX REV. 83, 87 (2007). Under that definition, "[p]ersonal income [is] the algebraic sum of (1) the market value of rights
and thus is a more ideal regime under which to calculate a taxpayer's income tax liability as compared to traditional realization accounting.\textsuperscript{15} Most commentators agree that mark-to-market accounting reflects a person's income better than realization accounting.\textsuperscript{16} Furthermore, because under mark-to-market accounting a taxpayer is taxed on all of her investments annually,\textsuperscript{17} the tax law disrupts her choices less than realization accounting. That is, realization accounting produces a timing option: at the end of any taxable year, realization accounting creates an incentive for a taxpayer to sell depreciated securities in order to realize her loss (thereby offsetting a portion of her income for the year) even if, absent tax considerations, she would prefer to continue to hold the securities.\textsuperscript{18} At the same time, realization accounting produces a

\hspace{1em}exercised in consumption and (2) the change in the value of the store of property rights between the
beginning and end of the period in question.” \textit{Id.} (quoting \textsc{Henry Simons}, \textsc{Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy} 61–62 (1938)).


\textsuperscript{17} I.R.C. § 475(a).

\textsuperscript{18} See Schizer, supra note 2, at 1557–60 (discussing the lock-in effect). In fact, a number of provisions exist in the Code in response to such arbitrage transactions, including the straddle and wash sale rules. Under realization accounting, and absent the straddle rules, a taxpayer could own offsetting positions—for example, XYZ stock purchased at $100 and a put on XYZ stock at $98. If, on December 28, 2010, XYZ stock were worth $105, the taxpayer could sell the put, while waiting until January 1, 2011, to sell the stock. Unless there were catastrophic movement in the market over the course of those three days, she would have, under realization accounting, triggered her loss in 2010, without recognizing the corresponding gain until 2011. Congress enacted the straddle rules, which generally disallow the loss on a straddle in any given year except to the extent it exceeds the unrealized gain in the offsetting position. I.R.C. § 1092(a) (2006). The remaining portion of the loss is carried forward until the year in which the taxpayer recognizes the gain.

Alternatively, assume the taxpayer is long in XYZ stock with no offsetting short position. She believes that over the long term, the stock will go up and she intends to hold her XYZ stock for at least five years. On December 28, 2010, however, she notices the XYZ stock is $5 below the price at which she purchased it. She decides to sell, realizes her loss, and repurchases the same number of shares on January 2, 2011, for roughly the same price as that at which she sold it,
lock-in effect on gain positions irrespective of whether the taxpayer wants to continue holding the appreciated assets: because selling the security is a taxable event, the tax law gives her an incentive to continue to hold the security and defer any tax.\textsuperscript{19}

In addition, mark-to-market accounting does not require someone who makes significant numbers of trades to keep track of the individual basis of each of the securities she holds. Effectively, at the end of every year, the bases reset as the year’s gains and losses net against each other and are realized.\textsuperscript{20}

Mark-to-market accounting also helps taxpayers avoid several loss-deferral regimes, including the wash sale rules.\textsuperscript{21} In general, under the wash sale rules, if a taxpayer sells a security at a loss and acquires (or purchases an option or enters into a contract to acquire) substantially identical securities within the sixty-one-day period beginning thirty days before the sale, the taxpayer has entered into a wash sale, and the deduction for the loss is disallowed.\textsuperscript{22} Under mark-to-market accounting, however, the wash sale rules do not apply.\textsuperscript{23}

The mark-to-market regime taxes a trader’s gains at ordinary rather than capital gains rates.\textsuperscript{24} It balances this less-favorable treatment by characterizing losses as ordinary and fully deductible.\textsuperscript{25}

\textsuperscript{19} In fact, under I.R.C. § 1014(a)(1), if she holds an appreciated security until her death, her heirs will inherit the appreciated security with a tax basis equal to its fair market value as of the date of her death. Any appreciation in the value of the security as of that date remains permanently untaxed. IRC. § 1014(a)(1) (2006).

\textsuperscript{20} I.R.C. § 475(f).


\textsuperscript{22} I.R.C. § 1091(a) (2006).

\textsuperscript{23} Id. § 475(d)(1).

\textsuperscript{24} Id. § 475(d)(3)(A)(i).

\textsuperscript{25} This would create arbitrage opportunities if a trader were allowed to make a section 475(f) election after she knew how the year progressed. See infra Part V.
Because securities are risky investments, a trader does not know when she purchases a security or enters into a financial instrument whether she will have a gain or a loss. As long as the loss is fully deductible, however, in any particular year she is largely indifferent to the tax rate.

Along with its advantages, mark-to-market accounting presents two significant difficulties. First, it requires an electing trader to accurately value her securities at the end of each year. Valuing her securities takes time, effort, and money. Unless all of the trader’s securities are publicly traded, valuing securities may be difficult to do. Further, for most investors, realization accounting has one significant advantage over paying taxes on Haig-Simons income: no tax is imposed unless an investor has actually received money (or, in certain cases, other property), and therefore the investor has the...

26. Calling securities “risky” is not an entirely accurate statement. While the return on certain financial instruments is entirely risk based, the return on others, including common stock, is a combination of a time-value return and a risk-based return. See David I. Walker, Is Equity Compensation Tax Advantaged?, 84 B.U. L. REV. 695, 718 (2004) (“Over the long haul stock prices rise to repay investors for the time value of their money and their assumption of risk.”). However, the time-value portion of return becomes most relevant only in the long term. See, e.g., FRANK ARMSTRONG III, THE INFORMED INVESTOR 33 (2002) (“[M]arket risk is a short-term risk that dramatically decreases over time.”). Moreover, while it may nonetheless be preferable in a mark-to-market environment to separate the risk-based return from the time-value return, it is beyond the scope of this Article to attempt to delineate a bright line between the portion of a security’s return that constitutes a time-value-based return and the portion that constitutes a risk-based return. For purposes of addressing the problems in the current elective mark-to-market regime, this Article will ignore the time-value component of investment returns.

27. It seems obvious that a trader would only purchase a security or enter into a financial instrument if she expected to earn a profit because of it, and she likely believes (subjectively) in her own ability to choose winning positions. Because the return on financial instruments is principally risk based (as opposed to plain-vanilla debt, for example, where the return is time based, or wage income, which is paid based on a person’s work and efforts), it is not objectively obvious in advance that the value will go up in spite of any particular taxpayer’s optimism or past track record.

28. See, e.g., Brunson, supra note 16, at 28–29; cf. Schizer, supra note 3, at 1897–98. At ordinary rates (using the highest federal marginal rate of tax), a gain of $100 will result in a tax liability of $35, whereas a loss of $100 will result in a deduction of $35. Because she does not know in advance whether she will have a gain or loss, and because the loss is worth as much to her as the gain, an economically rational taxpayer (mostly) does not care what the tax rate is. With financial instruments, she is entirely indifferent: because they are inherently levered, she can choose the after-tax return she wants and costlessly scale her investment up so that she will achieve that return. In order to scale up an investment in common stock, on the other hand, she would have to purchase two shares instead of one, which, while providing a scaled-up after-tax return, has additional up-front cost. Nonetheless, although she may prefer the higher return associated with long-term capital rates on gains, she also prefers the full deductibility and ordinary rate on losses, so that mark-to-market is, at worst, a wash for her economically.

29. See I.R.C. § 475(f).

30. See generally Schizer, supra note 2.
liquidity to pay the tax. Under a mark-to-market regime, tax is imposed annually, whether or not the taxpayer has sold any securities or otherwise received any money, and even if the taxpayer's investments are entirely in illiquid assets.\textsuperscript{31} Still, despite the administrative difficulties of being taxed on both realized and unrealized gains and losses, mark-to-market accounting reflects income better than realization accounting.\textsuperscript{32}

Several years after making mark-to-market accounting mandatory for dealers in securities, Congress made the same mark-to-market treatment available to traders in securities and to dealers and traders in commodities under an elective regime. Congress decided to give traders the option to mark their securities to market because it believed that mark-to-market accounting provides a "clear reflection of income with respect to assets that are traded in established markets" and because mark-to-market accounting offers fewer opportunities for manipulation.\textsuperscript{33}

A mark-to-market election may be made separately for each of the trader's trades or businesses. In order to elect mark-to-market treatment, a trader who is an individual or an existing entity must make the election no later than the due date of the tax return for the year prior to the year the election will be effective, which is April 15 and March 15, respectively, for individuals and business entities.\textsuperscript{34} A newly formed entity must state in its books and records, no later than two months and fifteen days after the beginning of its first taxable year that it has made the election, and it must also include the election with its tax return for its first year.\textsuperscript{35} Once made, the election is effective for the year of the election and all subsequent tax years and is irrevocable except with the consent of the commissioner of the Internal Revenue Service (IRS).\textsuperscript{36} An electing trader may designate

\textsuperscript{31} See Miller, supra note 3, at 1053.
\textsuperscript{32} See Musgrave, supra note 16, at 49 ("It is clear conceptually that unrealized gains constitute income, and a taxable income concept which in principle considers unrealized gains as nonincome is not a valid equity concept. To be sure, administrative difficulties do not permit full implementation of this principle, but recognition of what should be done in principle—temporarily disregarding administrative difficulties—is crucial in choosing between alternative feasible solutions." (citation omitted)).
\textsuperscript{33} STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 180 (Comm. Print 1997) [hereinafter 1997 BLUE BOOK].
\textsuperscript{34} Rev. Proc. 99-17 § 5.03(1), 1999-1 C.B. 503.
\textsuperscript{35} Id. § 5.03(2).
certain securities that are held for purposes other than the trade or business of securities trading. Any securities so designated will not be marked to market and will be subject to tax as if the trader had not made an election.\textsuperscript{37}

Making mark-to-market accounting elective for traders solves the biggest practical problems raised by mark-to-market accounting. Congress believed that exchange-traded securities had determinable market values and further believed that traders regularly calculated the year-end values of their assets in determining their income for financial-reporting purposes.\textsuperscript{38} In addition, the fact that mark-to-market accounting is an elective regime means that traders who elect section 475(f) know what to expect. Upon electing mark-to-market accounting, they are affirming that they are willing and able to value their trading portfolios annually and that they will have the liquidity necessary to pay taxes that come due.

\section*{III. TRADE OR BUSINESS}

If a taxpayer is engaged in the trade or business of trading securities, she is considered a “trader” for tax purposes.\textsuperscript{39} If she is not engaged in this trade or business, she is considered an “investor” and a number of different tax rules apply to her.\textsuperscript{40} The phrase “trade or business” appears frequently in the Code and the Treasury regulations.\textsuperscript{41} In spite of its relative importance, however, the phrase is not defined in either place and has not been defined by the courts.\textsuperscript{42} Rather, the determination of whether a taxpayer is engaged in a trade or business is generally made using a facts-and-circumstances test.\textsuperscript{43} This test has been extensively developed by the

\begin{itemize}
\item \textsuperscript{37} Id. § 475(f)(1)(B).
\item \textsuperscript{38} 1997 BLUE BOOK, supra note 33, at 180–81.
\item \textsuperscript{39} Id.
\item \textsuperscript{40} Id.
\item \textsuperscript{41} See F. Ladson Boyle, \textit{What Is a Trade or Business?}, 39 TAX LAW. 737, 737 (1986) (stating that, as of the writing of the Article, “trade or business” appeared in at least 492 sections of the Code and 664 regulations).
\item \textsuperscript{42} Id. at 738. It is worth noting that “trade or business” is not the only important concept in the Code without a statutory or regulatory definition. For example, neither “insurance” nor “insurance contract” is defined in the Code or in the Treasury regulations. Instead, taxpayers must derive a definition from judicial statements. Rev. Rul. 2008-8, 2008-1 C.B. 340.
\item \textsuperscript{43} See Higgins v. Comm’r, 312 U.S. 212, 217 (1941) (explaining that determining whether the activities of a taxpayer qualify as “carrying on a business” requires an examination of the facts in each case).
\end{itemize}
judiciary and analyzed in scholarly literature. Still, the test is fact intensive, and the result is often unclear, consisting of, among other things, the number of trades made in a year, the frequency of those trades, and the investment objective.

As difficult as the trade-or-business criteria may be to apply after the close of the taxable year, this Article demonstrates that they are impossible to apply prior to the end of the year, as is required in order to make the mark-to-market election. In order to provide taxpayers with certainty when they want to elect to be taxed on a mark-to-market basis, it is necessary for the Code to provide certainty about who may elect mark-to-market taxation.

**Uses of “Trade or Business” in the Code**

In order for a taxpayer to be engaged in a trade or business, it is insufficient for the taxpayer to merely seek a profit. Rather, “[t]he phrase ‘trade or business’ must refer . . . to extensive activity over a substantial period of time during which the [t]axpayer holds himself out as selling goods or services.” Traditionally, courts and the IRS have looked to four factors to determine whether a taxpayer is engaged in a trade or business: (1) a profit motive; (2) extensive activity sustained for a substantial period of time; (3) whether the activity has already begun; and (4) whether the taxpayer holds herself out as engaged in the selling of goods and services.

These criteria do not apply perfectly to the business of trading in securities. In order to differentiate an investor in securities from a trader in securities, courts generally look to whether one purchases securities to be held for capital appreciation and income (without


46. See, e.g., Rentenbach & Sowell, supra note 45, at 319 (“The presumptive approach of courts and commentators to the issue of . . . property for sale in the normal course of a trade or business[,] should be stripped of its patented formulas and reexamined.”).


48. See Boyle, supra note 41, at 739.
significant regard to the short-term swings in the market), in which case one is an investor, or whether one buys and sells securities frequently in order to exploit and profit from short-term market swings, in which case one is a trader. The cases offer no bright-line rule for the number or frequency of trades above which a taxpayer will qualify as a trader. There are, however, clear examples of levels of activity that are insufficient to support a claim that a taxpayer is a trader. For example, two trades over the course of a year are generally insufficient to allow a person to qualify as a trader.

The proper classification of a taxpayer becomes less clear as the quantity of a taxpayer's trades increases. In Moller v. United States, for example, the court accepted that Mr. and Mrs. Moller treated their investment activities as full-time jobs, each spending approximately forty hours per week monitoring the stock market and making investment decisions. In one year, they purchased securities in eighty-three transactions and sold securities in another forty-one. The next year, they engaged in seventy-six purchase and thirty sale transactions. However, the court determined that they were primarily seeking long-term growth and that they derived the bulk of their income from interest and dividends rather than from trading. The court therefore found that they were not engaged in the trade or business of trading securities and that they were investors and not traders.


50. Spring v. United States, 38 A.F.T.R.2d (RIA) 76-5533, 76-5536 (E.D. Tex. 1976). The court noted that, in addition to entering into merely two capital transactions during the year in question, plaintiffs Mr. and Mrs. Spring held both securities for more than six months before selling them. In the court's opinion, this clearly demonstrated that they were not trying to profit from short-term swings in the market. Id. at 76-7735.

51. 721 F.2d 810. The Mollers (and other U.S. taxpayers) would prefer to be treated as traders because section 162 permits a traders to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a) (2006). If the taxpayer's investment activities do not qualify as a trade or business, on the other hand, she is considered an investor rather than a trader, and her investment expenses are miscellaneous itemized deductions. Id. § 67(b). If she is not a trader, then she may deduct only her investment expenses if and to the extent that her aggregate miscellaneous itemized deductions exceed 2 percent of her adjusted gross income. Id. § 67(a). Therefore, it is in a domestic taxpayer's best interest to be considered a trader in securities, rather than merely an investor.

52. Moller, 721 F.2d at 811.

53. Id.

54. Id. at 812.

55. Id. at 814.
In *Estate of Yaeger v. Commissioner*, the court sussed out from the various trade-or-business precedents "two fundamental criteria that distinguish traders [in securities] from investors": the length of time a putative trader holds the securities and the source of her profit. Like the *Moller* court, the court here acknowledged that Mr. Yaeger had "pursued his security activities vigorously and extensively." Mr. Yaeger had also carried a significant margin of debt related to his investment activities; moreover, he had initiated more than two thousand securities transactions over the course of the two years in dispute, more than fifteen times the number of transactions the Mollers had entered into over the same period of time.

Nonetheless, the court held that Mr. Yaeger had not been engaged in the trade or business of trading securities. The court based its decision on two factors. First, Mr. Yaeger held most of his securities for more than one year and held none for less than three months. Second, although he earned some income from dividends and interest, he made most of his profit by holding undervalued stock until the market improved. The court held that his emphasis on capital growth and profit from the resale of securities indicated that he was an investor rather than a trader.

Although the court based its holding on its two fundamental criteria, the opinion strongly suggests that the court viewed Mr. Yaeger's attempted deduction as both abusive and directly contrary to the Code. The potentially abusive nature of the claimed

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56. 889 F.2d 29 (2d Cir. 1989).
57. *Id.* at 33.
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.* at 34.
63. *Id.*
64. *Id.* In fact, although courts strive to interpret "trade or business" in the same way throughout the Code, the focus on number of trades indicates that they do not do so consistently even across different types of trades or businesses. In the real estate area, for example, it is possible for the courts to find a trade or business in the case of an isolated sale of a single piece of real property. S&H, Inc. v. Comm'r, 78 T.C. 234, 245 (1982); see also Rentenbach & Sowell, *supra* note 45, at 353–54.
65. While the court did not point to the amount of leverage Mr. Yaeger employed in order to carry his investments as the reason for finding that he was an investor rather than a trader, there was a strong undercurrent of suspicion in the opinion about his good faith in claiming a deduction
MARK-TO-MARKET TAXATION

Winter 2010]

521
deduction seems to have been compounded in the court’s mind by
the imbalance between the ordinary character of his claimed
deductions and the (generally long-term) capital character of the
income he would ultimately earn.66

In Adda v. Commissioner,67 the Tax Court considered whether
Mr. Adda, a nonresident alien individual, was engaged in a trade or
business in the United States by virtue of commodity futures
transactions that his brother entered into on his behalf. Mr. Adda had
authorized his brother, a resident of New York, to trade on U.S.
commodity exchanges on his behalf.68

During 1941, Mr. Adda was cut off from his brokers and his
brother for at least some of the year. During that year, Mr. Adda had
net gains of $193,857.14 on the commodities transactions entered
into by his brother on his behalf.69

The court stated that “[t]rading in commodities for one’s own
account for profits may be a ‘trade or business’ if sufficiently
extensive.”70 Mr. Adda’s trading would have constituted a trade or
business had he been a U.S. resident during 1941, and the court
decided he should not escape such treatment solely by virtue of

for the interest expense. The court highlighted the legislative history of section 163(d) of the
Code, which disallows individual investors from taking a deduction for interest paid to carry
investments; this section was enacted to prevent investors from deferring capital gain income on
securities purchased with leverage while currently deducting the interest on that leverage. Yaeger,
889 F.2d at 32–33.

66. In 1979 and 1980, gain on the sale of an asset held for more than one year was
considered long-term capital gain. The top marginal tax rate was 70 percent for those years, while
the long-term capital gain exclusion for those years was 60 percent, meaning the effective rate on
long-term capital gain was 28 percent. Leonard Burman & Deborah Kobes, Preferential Capital
Gains Tax Rates, 102 TAX NOTES 411 (Jan. 19, 2004); see I.R.C. § 1202 (1980) (“If for any
taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of
the net capital gain shall be a deduction from gross income.”). This means that, if Mr. Yaeger had
been permitted to deduct his interest income at ordinary rates, he would have been able to reduce
his ordinary income by 70 percent of his interest expense, while any gain he realized in that same
period would have been taxed to him at 28 percent. Were the mark-to-market election available in
1979, permitting him to have made an ex post mark-to-market election would not have created
the same arbitrage opportunities. Rather, both his losses and gains would have been fully taken
into account each year at ordinary rates.

67. 10 T.C. 273 (1948). A foreign person or entity engaged in a trade or business in the
United States becomes subject to the U.S. federal income tax at ordinary tax rates. I.R.C.
§§ 871(b), 882(a) (2006). Before the enactment of section 864(b)(2), foreign persons investing in
U.S. securities had to worry about whether their trading activities caused them to be engaged in a
U.S. trade or business.

68. Adda, 10 T.C., at 274.

69. Id. at 275.

70. Id. at 277 (quoting Fuld v. Comm’r, 139 F.2d 465 (1943)).
having transacted through his brother, whom the court considered the equivalent of an agent resident of the United States. 71

On the other hand, the Tax Court found in Liang v. Commissioner 72 that Mr. Liang was not engaged in a U.S. trade or business. Mr. Liang was also a nonresident alien individual who was not present in the United States during the year in controversy. 73 Like Mr. Adda, Mr. Liang authorized a U.S. resident to manage his investments. 74

The court held that Mr. Liang was not engaged in a U.S. trade or business by virtue of the securities transactions his agent entered into on his behalf. 75 Because the court was convinced that the primary objective of Mr. Liang's investments was to provide him with a reliable source of income, it determined that his agent's actions did not cause him to be engaged in a trade or business. 76

Although courts have laid out a four-factor test to evaluate whether a taxpayer is engaged in a trade or business, the test does not fit well with a trader in securities and becomes a much more complicated exercise. Courts look to some objectively determinable factors, such as the number of trades made by a taxpayer, their frequency throughout the year, and the source of the taxpayer's gains. 77 Courts also look to subjective factors, including the taxpayer's objective in making those trades. 78 The test is generally complicated and unclear even after the taxable year has ended and

71. Id. at 278.
72. 23 T.C. 1040 (1955).
73. Id. at 1041.
74. Id. Unlike Mr. Adda, Mr. Liang paid his U.S. agent, although the court made no use of this fact beyond its mere mention.
75. Id. at 1045.
76. Id. The court bolstered its conclusion that the activities of Mr. Liang's agent did not cause Mr. Liang to be engaged in a U.S. trade or business by pointing out that, during four of the seven years his agent acted on his behalf, capital transactions resulted in losses rather than gains, and in another two, they resulted in insignificant gains. Id. However, this analysis, which focuses on the results of an investor's transactions, seems ill suited to determining whether a person is a trader or an investor, even using hindsight. That Mr. Liang's capital transactions resulted in a net loss for more than half of the years the court examined may indicate that he intended to earn money from dividends and long-term appreciation (i.e., as an investor). But it may equally well demonstrate that he (through his agent) was an unsuccessful, unlucky, or untalented trader.
77. E.g., Moller v. United States, 721 F.2d 810, 813 (Fed. Cir. 1983); Liang, 23 T.C. at 1043.
78. E.g., Moller, 721 F.2d at 813.
the facts are determinable. The test is unworkable as applied before the taxable year has ended and the facts exist.

IV. TRADE OR BUSINESS FOR PURPOSES OF THE MARK-TO-MARKET ELECTION

A handful of cases have attempted to apply the trader-in-securities test discussed in Part III to a putative election under section 475(f). For example, Frank Chen, the plaintiff in the lead case in this area, "Chen v. Commissioner," had a full-time job and, in addition, maintained two brokerage accounts. In 1999, along with a sizeable number of Americans, he tried his hand at day-trading. During that year, he initiated 323 transactions involving the purchase or sale of securities. Almost 94 percent of his transactions occurred between February and April, and all of his day-trading occurred between January and May, except for four trades that occurred in July. Mr. Chen's skill as a day trader seems to have been commensurate with that of many day traders who lost money in the wake of the dot-com collapse: he claimed a net loss of $84,794 from his trading for the year.

79. It is worth noting that in each of the section 475(f) cases, the taxpayer had attempted to make a mark-to-market election after the date on which the election is required to be made. The courts look separately at whether the taxpayer is a trader and at whether the taxpayer qualifies to make the election late. Failing either prong causes the taxpayer to lose.
80. 87 T.C.M. (CCH) 1388 (2004).
81. Id. at 1389.
82. See, e.g., Geoffrey P. Miller, Capital Markets on the Internet, 5 N.Y.U. J. LEGIS. & PUB. POL'Y vii, ix (2001) ("Similarly, the ease of individual trading that the Internet facilitates has sparked the explosive growth, in the late 1990s, of day traders . . . ."); Matt Krantz, Day Trading: A Great Way to Lose It All, USA TODAY, Oct. 3, 2005, http://www.usatoday.com/money/perfi/columnist/krantz/2005-10-03-day-trade_x.htm ("Day trading got very popular during the late 1990s as many people saw the stock market soar to incredible heights in a short period of time.").
83. "Although day traders have historically been professional traders, the term 'day trader' now often refers to nonprofessional securities traders whose patterns of securities trading are different from those of ordinary investors." Caroline Bradley, Disorderly Conduct: Day Traders and the Ideology of Fair and Orderly Markets, 26 J. CORP. L. 63, 63 (2000).
84. Chen, 87 T.C.M. (CCH) at 1388.
85. Id.
86. Miller, supra note 82, at ix ("Mr. Myers's observation that things change at light speed in the industry is borne out by the equally rapid fall off in day trading in the wake of the bursting of the dot-com and tech-stock bubbles."); Krantz, supra note 82 ("And during [the late 1990s], many investors did profit handsomely. But many of these same investors were subsequently destroyed when the vicious bear market ravaged the Nasdaq, Internet stocks and then the broad market.").
87. Chen, 87 T.C.M. (CCH) at 1388.
Mr. Chen did not attempt to make a mark-to-market election until 2003, when he purported to make an election under section 475(f), effective retroactively to January 1, 1999.88 In determining whether he was eligible to make the election, the court initially ignored the question of whether he qualified to make a retroactive election and instead analyzed whether he was a trader or an investor using principles from the trader-or-investor line of cases. The Tax Court stated that, in order for Mr. Chen to be a trader, his purchase and sale of securities had to qualify as a trade or business.89 The court looked to two factors: the volume of his trading and the regularity with which he engaged in the purchase and sale of securities.90

The court acknowledged that Mr. Chen made daily trades during February, March, and April but also recognized that he made no trades during six months of 1999.91 And in the remaining three months, he made only twenty of his more than three hundred trades for the year.92 The court determined that daily trading for a quarter of the year, with infrequent or no trading during the rest of the year, was not “frequent, regular, and continuous”93 trading and did not meet either factor necessary to establish that he had engaged in the trade or business of trading securities. The court further pointed to the fact that his job, rather than his day-trading, was Mr. Chen’s primary remunerative activity.94 Therefore, the court held, Mr. Chen

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88. While it is not clear why Mr. Chen waited over three years to make the election, it became clear as of the close of 1999 that the election was in his best interest. Absent the election, he had a capital loss of $84,794, deductible only if and to the extent that it exceeded 2 percent of his adjusted gross income, I.R.C. § 67 (2006), and deductible only against capital gain plus $3,000 of ordinary income. Id. §§ 165(f), 1211(b) (2006). With the election in place, however, his full loss would be ordinary in character, deductible in full against any income, including wage income. Id. § 475(f)(1)(A)(ii) (2006).

89. Chen, 87 T.C.M. at 1389.

90. Id. at 1390.

91. Id.

92. Id.

93. Id. at 1388 (quoting Boatner v. Comm’r, 74 T.C.M. (CCH) 342, 345 (1997)).

94. The emphasis the court placed on the fact that Mr. Chen’s primary source of income was his work as an engineer in explaining why his trading activities did not constitute a trade or business seems odd, at best, and exemplifies the confusion inherent in requiring that a taxpayer be a trader in order to make a mark-to-market election. Although it is relatively clear that Mr. Chen’s attempt to retroactively elect to be taxed on a mark-to-market basis was an attempt to profit from his ex post knowledge in a manner and time inconsistent with the Code and the Treasury regulations and, thus, the court was correct to deny his claim, the court was clearly wrong that engaging in one trade or business precludes a taxpayer from engaging in any other. The Code,
was not engaged in the trade or business of trading securities, which meant that he was an investor, not a trader, and that the mark-to-market election under section 475(f) was unavailable to him. Because it determined that he could not, in any event, make the election, the court declined to address his contention that he should have been permitted to make the election late.

In *Acar v. United States*, the court also dealt with a taxpayer’s attempt to make a late section 475(f) election. Plaintiff Kazim Z. Acar alleged that he was a professional in the financial services industry and a securities trader. In 1999, he sustained a net loss from his trading activities, which he initially claimed as a capital loss on his 1999 return. In 2002, he filed an amended return, in which he purported to elect to mark his securities gains and losses to market under section 475(f), causing his trading losses to be ordinary rather than capital and claiming a refund of $46,396.

Mr. Acar claimed that he met the standards enunciated in *Chen* to be treated as a trader: he testified that he devoted six to eight hours a day to trading activities nearly every day and that the number of trades he made in 1999 averaged nearly two trades a day. The government countered that, although his trades may have averaged two a day, he actually made trades on less than half of the days in each month and that he did not trade at all between June and August. The government further argued that Mr. Acar’s primary

regulations, and case law are all clear that a person may engage in multiple trades or businesses in various contexts. I.R.C. § 446(d) (2006) ("A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business."); Phila. Quartz Co. v. United States, 374 F.2d 512, 515 (Ct. Cl. 1967) ("Surely taxpayers can be in multiple trades or businesses . . . ."); Treas. Reg. § 1.1446-3(e)(4) ex.1 (2005) ("B is engaged in multiple trades or businesses (including the PRS partnership) that give rise to effectively connected income."); *accord* Schwartz, *supra* note 45, at 439 ("It is beyond dispute . . . that a taxpayer can be engaged in more than one trade or business."). The court seems to have found the fact that securities trading was not Mr. Chen’s primary source of income helpful in bolstering its holding, however, and in the interest of preventing Mr. Chen from taking advantage of his hindsight knowledge, created precedent making it even more difficult for a taxpayer to know ex ante whether he qualifies as a trader.

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96. *Id.* at *2.
97. *Id.* at *1.
98. *Id.*
99. *Id.* at *2.
100. *Id.*
source of income in 1999 and throughout subsequent years was his life insurance and mutual fund sales business.  

In contrast to the Chen court, the district court in this case determined that, although Mr. Acar’s statements on his tax return suggested that he was not a trader, he had proven the existence of a material disputed fact, which would have been sufficient to survive the government’s motion for summary judgment. He had not, however, made a timely election. The court determined that Mr. Acar had not met the regulatory requirements to make a late election. The court, therefore, dismissed Mr. Acar’s case.

Both courts clearly came to the correct conclusion. The taxpayers were acting with hindsight, knowing that they had a loss rather than a gain before attempting to make the election. Admittedly, the taxpayers faced potential ordinary rather than capital gains in the future from trading activities: the section 475(f) election is irrevocable without permission from the secretary of the Treasury Department. However, they knew that they had a loss for the first year. If they were concerned about future gains being ordinary rather than capital, the plaintiffs in the cases could—by ceasing to invest and divesting their portfolios or by reworking their portfolios to include solely bonds and other investments on which gains are treated as ordinary by default—ensure that they would never have an offsetting gain that was, by virtue of their section 475(f) election, recharacterized as ordinary. Moreover, as a consequence of the time

101. Id.
102. Id. at *3.
103. Id.
104. Id. at *5. The court found not only that Mr. Acar had failed to demonstrate that he had acted in good faith but that his motivation seemed “the classic definition of ‘hindsight.’” Id. Although trader-or-investor analysis was not determinative of the outcome of Acar, in deciding that Mr. Acar would have survived the motion for summary judgment on that point, the district court used the same analysis that the Tax Court had used in Chen. There is no reason to believe that, had the case gone to trial, the court would not have analyzed the investor-or-trader issue in exactly the same way.
106. Interest income is ordinary. United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965) ("[S]tated interest [is] concededly ordinary income and not a capital asset . . . ."). Returns on debt tend to be less risky, so a portfolio that included only debt would tend to provide lower returns for the investor, and its lack of diversification would make the portfolio dangerously susceptible to adverse movements in interest rates and other credit risks. But, although a debt-only portfolio would appear to be undesirable, it would nonetheless allow the investor to avoid any downside to a section 475(f) election after she realized a benefit in the first year.
value of money, the present value of a current deduction outweighs the present value of an equivalent future inclusion in income.\textsuperscript{107}

V. WHY THE JUDICIAL TRADE-OR-BUSINESS CRITERIA DO NOT WORK

In spite of the uncertainty relating to whether a taxpayer is deemed a trader or an investor, the facts-and-circumstances analysis developed by the courts and adopted by the IRS ultimately works for purposes of determining both whether investment expenses are miscellaneous itemized deductions and whether a non-U.S. person is engaged in a trade or business in the United States. In both cases, a person determines ex post whether her investment activities constituted a trade or business. Individuals are not required to file their tax returns until April 15,\textsuperscript{108} and corporations not until March 15,\textsuperscript{109} of the following year. This means that after the relevant year is over, individuals have three and one-half months in order to determine whether, in the prior year, their investment activities constituted a trade or business.

In spite of the fact that for most purposes a person can determine whether she is a trader or an investor after the tax year ends, Congress recognized in the international area that the law "was chaotic, with the line between trading as a business and trading as an investment being drawn case by case according to the frequency of trades and the average length of holdings."\textsuperscript{110} As a result, Congress amended the Code to provide that trading in stocks, securities, and commodities would not constitute a trade or business in the United States.\textsuperscript{111}

\textsuperscript{107} Schizer, supra note 3, at 1909 ("By keeping appreciated investments, [taxpayers] can defer gains (thereby reducing the present value of the tax). By selling depreciated property, they can accelerate losses (thereby preserving the present value of deductions).").

\textsuperscript{108} I.R.C. § 6072(a) (2006).

\textsuperscript{109} I.R.C. § 6072(b). Furthermore, as a matter of course, most taxpayers can get an automatic six-month extension in which to file their tax returns. Treas. Reg. § 1.6081-3(a) (2008) (for corporations); id. § 1.6081-4T(a) (for individuals).

\textsuperscript{110} Joseph Isenbergh, The "Trade or Business" of Foreign Taxpayers in the United States, 61 TAXES 972, 981 (1983).

\textsuperscript{111} I.R.C. § 864(b)(2) (2006); see H.R. REP. No. 89-1450, at 13 (1966) ("[Y]our committee has amended present law to specifically provide that, except in the case of a dealer, the trading in stocks, securities, or commodities in the United States, for one's own account, whether by a foreign person physically present in the United States, through an employee located here, or through a resident broker, commission agent, custodian, or other agent—whether or not that agent has discretionary authority—does not constitute a trade or business.").
Beyond being merely chaotic, however, the courts’ investor-or-trader analysis is useless to taxpayers who want to make a timely election. The courts adopted the trade-or-business analysis used in section 162 deduction cases, focusing especially on frequency and consistency of trading. Factors such as frequency of trading and whether trading occurred to capture gains based on short-term swings in the market work fine for purposes of determining whether a loss is fully deductible or whether a taxpayer who makes a late election was an investor in a prior year. A taxpayer does not file her return until April of the following year, which means that, by the time she has to determine whether her investment losses are miscellaneous itemized deductions or are fully deductible, she knows how frequently and consistently she participated in trading activities. Furthermore, for most purposes in the Code, it is possible to be a trader in some years and an investor in others.

It makes sense, of course, that courts would develop an ex post test. Courts do not have jurisdiction until there is a case or controversy. In the case of a tax controversy, in order for jurisdiction to vest in a federal district court or the Court of Federal Claims, a taxpayer must have paid the full tax assessed (albeit under protest) and then sued for a refund, while for a case to be heard in the Tax Court, the taxpayer must have received a deficiency notice.

112. They arguably should not have been relevant in the late election cases, however. The courts could have focused solely on whether the taxpayer was eligible to make a late election. The Treasury regulations require that, in order to make a late election, a taxpayer must request an extension of time from the Treasury Department and, in order to be granted the extension of time, must establish that she acted reasonably and in good faith and that the extension will not prejudice the interests of the government. Treas. Reg. § 301.9100-3(a) (1967). The Acar court found that Mr. Acar had not met the requirements, and the Chen court arguably could have come to the same conclusion. In that sense, it is unfortunate that the Chen court chose to base its outcome on the investor-or-trader distinction because, given that this is the lead case in the area, it is likely that future courts will continue to address the trader-or-investor distinction, even if they ultimately base their decision on the qualification to make a late election.


114. U.S. CONST., art. III, § 2; see also Sterner v. U.S. Drug Enforcement Agency, 467 F. Supp. 2d 1017, 1025 (S.D. Cal. 2006) ("A federal court’s judicial power is limited to ‘cases’ or ‘controversies.’").

115. Flora v. United States, 362 U.S. 145, 177 (1960) ("Reargument has but fortified our view that § 1346(a)(1), correctly construed, requires full payment of the assessment before an income tax refund suit can be maintained in a Federal District Court.").

courts, then, the relevant facts are in the past, and the court is in a position to analyze the facts and circumstances. 117

Deciding whether to make the mark-to-market election is not, however, amenable to an ex post facts-and-circumstances test. As mentioned above, individuals and existing entities that decide to mark their trading gains and losses to market must make the election no later than the date on which their tax return is due (ignoring any extensions requested or granted) for the year prior to the year for which the election will be effective. 118 For a new taxpayer, the election must be made by March 15 if she uses the calendar year to calculate her tax liability. 119 In other words, a taxpayer must make the election before there are any facts or circumstances with respect to her trading activities. Making the election is a quintessentially ex ante decision.

Furthermore, the election is perpetual, unless revoked with the consent of the secretary of the Treasury Department. 120 When the requirements are taken at face value, then, a taxpayer must not only know whether she will be engaged in the trade or business of trading securities for the current year 121 but also know whether she will be so engaged in two years, in five, in ten, and so on. The Code does not provide any guidance for the electing trader who ceases to be a trader, either accidentally or because she altered her investment strategy. Moreover, it would be unfair to force her to choose between keeping an investment strategy she no longer wants in order to remain eligible for the mark-to-market election or to change her investment strategy and possibly lose her election. 122 Because the

117. Even in those cases where a court looks to the taxpayer’s state of mind at the time she entered into the transaction, everything relevant to the transaction has occurred. That is, even when a court analyzes a taxpayer’s intentions, the court can do so only when it knows how the transaction turned out.
119. Id. at § 5.03(2).
121. As discussed supra, although the election is ex ante, it is technically made within two and one-half to three and one-half months of the beginning of the year to which it will apply. When she makes the election, therefore, our putative trader will have knowledge of where the market, and more importantly her investments, went over the course of roughly the first quarter. However, assuming that investments in securities are truly risky, their performance over the first three months of the year in no way presages whether she will end her year with a net gain or a net loss.
result of changing her investment strategy is so unclear, the decision becomes even more costly to her.123

In general, it makes economic sense for somebody who invests for the short term (i.e., who holds a majority of her investments for one year or less) to elect mark-to-market treatment.124 Short-term capital gains are taxed at ordinary rates,125 but short-term capital losses are deductible only to the extent of the capital gains plus $3,000.126 A mark-to-market election would be a win-win situation for a trader, then. Her gains would be taxed at the same rate, while her losses would be fully deductible. Furthermore, a trader with a significant quantity of investments would not be required to keep track of the basis of each security she owns.127

Although the courts established the criteria used to determine whether a taxpayer is engaged in the trade or business of trading securities, even assuming judges recognized the need to craft the rule into a form that would work for section 475(f), they are not in a position to clarify the standards a taxpayer must meet in order to qualify to elect mark-to-market accounting, for a number of reasons. Principal among these reasons is the fact that courts can hear only

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122. The markets can turn on a dime, necessitating sometimes a change in investment strategy. For the first six months of 2006, for example, the economy seemed to be growing comfortably, and the word subprime was virtually unknown. However, at the end of 2006, the first subprime lenders began to fail, and even as subprime lenders announced that any blowback was an overreaction, the failures built up steam until, by July and August of 2007, "this slowly building wave became a tsunami in the global financial markets." Nelson D. Schwartz & Vikas Bajaj, How Missed Signs Contributed to a Mortgage Meltdown, N.Y. TIMES, Aug. 19, 2007, at A1. It would be unfair and unreasonable to require an electing trader to stand by her strategy in light of a sea change of this magnitude, solely to maintain her qualification to make the election she already made, especially where it is unclear what happens if she fails to qualify after making the election.

123. Because it is unclear what the answer is, our trader or investor would likely, at bare minimum, have to pay tax attorneys or accountants to try to determine the correct answer, and because there currently appears to be no ascertainable correct answer, even then she would not be likely to receive significant comfort.

124. Schwartz, supra note 45, at 426. Schwartz notes that one exception to this general rule is where a taxpayer has a capital loss carryover. Id. at 426 n.172.

125. Short-term capital gains are not included in the definition of "net capital gain," I.R.C. § 1222(11) (2006), and are therefore not eligible for the preferential capital gain tax rates. Id. § 1(h)(1) (2006).

126. Id. §§ 165(f), 1211(b)(1) (2006).

127. Schwartz believes that the IRS's position is that, in order to be a trader, a taxpayer must be buying and selling securities on the same day, which would at least partially ameliorate the record-keeping burden. Schwartz, supra note 45, at 431. However, he believes that such a strict requirement is not supported by case law and that a trader should be able to hold securities for longer than a day. Id. at 431–32.
cases and controversies. At the time the taxpayer must make the election, however, there is no controversy. The controversy only arises when the IRS disallows the election, and it appears that the IRS currently disallows elections principally, if not exclusively, when a taxpayer attempts to make a late election. Unless and until the IRS challenges a timely election, then, the question of what constitutes trader status will not be addressed by the courts.

Moreover, even if such a case did arise, and even assuming that the judge was sympathetic to the taxpayer’s dilemma, it is unclear that, in light of the doctrine of stare decisis, the judge would have any leeway in interpreting section 475(f). Courts interpret the phrase “trade or business” consistently across the Code. There is no ambiguity to resolve, and the standard for being engaged in a trade or business is well established, if unhelpful in this situation. Any solution, then, would have to be enacted by Congress through an amendment of the Code, or by the Treasury Department through the promulgation of regulations.

VI. A NEW REGIME FOR MARK-TO-MARKET ELECTIONS

A. Eliminating the Mismatch

As this Article has demonstrated, requiring a taxpayer to be engaged in the trade or business of trading securities as a prerequisite for making a mark-to-market election does not work. An ex post test and an ex ante election are a poor match. In light of the virtual impossibility of reconciling the two, it would behoove Congress to

130. Piedad Alvarado deKrause v. Comm’r, 33 T.C.M. (CCH) 1362 (1974) ("The words 'trade or business' are terminology familiar to the tax law that should be interpreted consistently with the general body of law on this subject."). It is not explicit in the Code, in the Treasury regulations, or in the congressional reports that a trader in securities is equivalent to a person who engages in the trade or business of trading in securities. Schwartz, supra note 45, at 426–27. However, the Joint Committee on Taxation’s General Explanation clarified that equivalence. Id. at 428 (citing 1997 BLUE BOOK, at 180). Although the General Explanation is not law, it is probably an accurate description of Congress’s intent. In any event, the courts have adopted the requirement that, in order to elect mark-to-market treatment, a trader in securities must be engaged in the trade or business of trading securities, see supra Part IV, so that requirement is effectively part of the tax law.
131. See generally Lopez, supra note 44 (surveying the use of the trade-or-business distinction in a broad cross section of cases).
set the mark-to-market election free of the doctrinal constraints of a trade or business, like it freed non-U.S. investors from the trade-or-business constraints more than forty years ago, especially in light of the fact that the mark-to-market election better reflects Haig-Simons income.

Congress did not explain why it chose to limit the election to traders, 132 which leaves only conjecture about why it imposed the limit. Presumably it was (a) because of discomfort with nonrealization accounting (i.e., for historical reasons); (b) in order to protect taxpayers from being subject to taxes they could not afford to pay (i.e., for paternalistic reasons); or (c) because Congress was worried that, at the margins, there would be tax arbitrage available if investors were permitted to mark their securities and commodities investments to market (i.e., for strategic reasons). None of these, however, is a compelling reason to prevent non-traders from being able to elect to use mark-to-market accounting.

Since the inception of the income tax, realization accounting has underlain the responsibility to pay taxes on gains and other income. 133 Although it does not reflect Haig-Simons income, a realization system has one distinct advantage: when a taxpayer is taxed only after she disposes of an appreciated asset, she has liquid assets with which to pay her tax bill. 134 Having the liquid assets necessary to pay the tax bill promotes both fairness and compliance: compliance because the taxpayer is more likely to pay when she has cash on hand, and fairness because she is capable of paying her tax liability.

Nonetheless, realization accounting is a second-best solution. Rather than promoting and protecting it, Congress should encourage taxpayers, where possible, to report and pay taxes on their true economic income, rather than on only the income that they have realized. Even though the Code has historically preferred realization accounting, 135 history should not be a primary consideration in formulating tax policy.

The paternalism justification is slightly more persuasive: because an electing taxpayer must pay taxes each year on the

132. See supra text accompanying notes 32–38.
133. See Potter, supra note 3, at 879; Weisbach, supra note 3, at 96.
134. See Brunson, supra note 16, at 28.
135. See Schenk, supra note 3, at 375.
increase in the net asset value of her investments—and because, once made, the election cannot be easily revoked—Congress perhaps intended to protect taxpayers from themselves. 136 Under this formulation, trader status may represent a proxy for financial savvy. That is, while anybody can invest, it takes a base level of engagement to be a trader, and presumably, a trader has enough economic knowledge to understand the consequences of mark-to-market accounting.

Nonetheless, mark-to-market accounting better reflects true income and should be available to those who want it. Although trader status may be useful as a proxy for economic understanding, it is not by any means the only possible proxy. Because the election is opt-in rather than opt-out, 137 it requires a certain baseline understanding of taxes, and presumably, any taxpayer who has expended the effort to understand that the section 475(f) election exists, how the election works, and how to make the election has a sufficient knowledge base to be allowed to make the election if she determines it is in her best interest. There is nothing inherent about engaging in a trade or business that causes a taxpayer to understand the implications of paying taxes on Haig-Simons income. Likewise, there is nothing inherent in not trading sufficiently to be considered engaged in a trade or business that would prevent a taxpayer from understanding the election. The act of making the election seems to be as good a proxy for the taxpayer’s understanding of what she is getting herself into as is being a trader.

Finally, there is the potential for tax arbitrage. Mark-to-market accounting, however, is difficult to arbitrage. As Professor David M. Schizer explains, mark-to-market accounting eliminates the timing

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136. Miller, supra note 3, at 1053.
137. This relates to the idea of “libertarian paternalism” (i.e., that we can design choices in such a way as to encourage people to make the more socially responsible choice, while still allowing them to choose). Richard H. Thaler & Cass R. Sunstein, Designing Better Choices, L.A. TIMES, Apr. 2, 2008, at A21. Libertarian paternalism posits, in part, that if we want people to act in a particular way, we make that the default option and allow them to opt out if they so choose. Id. (“If we want to increase savings by workers, we could ask employers to adopt this simple strategy: Instead of asking workers to elect to participate in a 401(k) plan, assume they want to participate and enroll them automatically unless they specifically choose otherwise.”). Here, however, by making realization accounting the default, the Code does not encourage taxpayers to choose mark-to-market accounting. Instead, by requiring a taxpayer to opt in to mark-to-market accounting, it makes sure that only people who are motivated (and, presumably, understand that they may be required to pay taxes even if they do not have liquid assets) are subject to the regime.
option. Instead, it treats all unrealized gains and losses as realized on the last day of each taxable year. In addition, mark-to-market accounting eliminates differences in character, treating all gains and losses as ordinary. Because it eliminates the timing option, mark-to-market accounting moots several anti-arbitrage provisions in the Code. Section 263, for example, disallows any deduction for interest and other carrying charges allocable to straddles, but the proposed Treasury regulations provide that the section does not apply to securities that are marked to market. Likewise, mark-to-market accounting eliminates the deferral opportunities of investing in offshore companies. In recognition of this, the punitive passive foreign investment company rules do not apply to securities subject to mark-to-market accounting.

In fact, the only attempted tax arbitrage stemming from the section 475(f) regime currently in place is the attempt by certain traders, after they know that they incurred a net loss during a year, to make a late election. Taxpayers who have tried to take advantage of their hindsight have been famously unsuccessful in convincing the courts to allow a late election. Moreover, if Congress is concerned about this possibility, it can prohibit late elections. Tax arbitrage, then, should not be an issue.

In addition, an elective tax regime, while beneficial to certain taxpayers, arguably contravenes certain basic tax policy considerations by, for example, adding complexity to the Code and violating horizontal equity without necessarily creating any benefit.

138. Schizer, Balance, supra note 3, at 1918.
139. Id.
140. See id. at 1894.
141. Prop. Treas. Reg. § 1.263(g)-1(b), 66 Fed. Reg. 4746, 4749 (Jan. 8, 2001). A “straddle” consists of two offsetting positions in a security (e.g., a long position and a short position in the same security). I.R.C. § 1092(c) (2006). Because the positions are offsetting, when one increases in value, the other decreases. Prior to the enactment of the straddle rules, a taxpayer could sell off the position that decreased in value, recognizing the loss. At the same time, she would continue to own the gain position, deferring recognition of the gain. See, e.g., John P. Bransfield, Proposal to Change the Federal Income Taxation of Marketable Securities, 2 HOUS. BUS. & TAX L.J. 328, 339–41 (2002). If the gain and loss on both positions were recognized every year, however, a taxpayer could not defer recognition of the gain and the arbitrage opportunity would disappear. Id. at 340–41.
143. See supra notes 79–107.
for the government. In spite of violating certain tax policy norms, however, elective mark-to-market accounting makes it easier to tax Haig-Simons income, even taking into account the practical advantages of a realization system. The benefits of a more theoretically sound system of tax should outweigh any detriments introduced by making mark-to-market accounting elective.

The trader requirement should be removed from section 475(f) because mark-to-market accounting reflects a taxpayer's income better than traditional realization accounting and eliminates several arbitrage opportunities that a taxpayer might otherwise have. Currently, there is no compelling reason to limit the availability of the election to traders in securities and commodities, and more importantly, there is vast uncertainty at the time the election must be made about whether a taxpayer qualifies to make the election (and about whether she will qualify in the future). Any taxpayer who so desires should be permitted to elect to mark her securities and commodities investments to market. Although administrative difficulties preclude the full implementation of mark-to-market accounting, expanding the availability of the mark-to-market election to all investors would promote fairness and certainty in the Code and would bring the Code closer to taxing Haig-Simons income to the extent it is administratively feasible.

B. The Safe Harbor

Alternatively, if Congress were to determine that continuing to limit the availability of the mark-to-market election was preferable to making the election available to all taxpayers, it would nonetheless be critical to clarify the prerequisites a taxpayer must meet in order to elect taxation on a mark-to-market basis. Although there are undoubtedly many possible and viable ways to clarify the currently ambiguous requirements that must be met in order for a trader to elect to mark her investments in securities or commodities to market, the remainder of this section in the Article will propose a new

145. E.g., Bradley T. Borden, Policy and Theoretical Dimensions of Qualified Tax Partnerships, 56 Kan. L. Rev. 317, 367 (2008) (“Tax policy does not support elective tax treatment.”); see also Start Making Sense, http://danshavro.blogspot.com/2007/11/fred-thompsons-bad-idea.html (Nov. 29, 2007) (“Taxpayer elections are almost always a bad idea. They add complexity while losing revenue, since taxpayers have an incentive to look at all the options and then pick the one under which they pay the least. Plus, the pattern of tax liability you get is bound to be incorrect, given its being a mix-and-match between different systems.”).
qualification regime for making a mark-to-market election an ex ante safe harbor. In addition, this section discusses two ways in which the safe harbor could be enacted. The first, an administrative solution, is simpler and is likely an easier route, provided the Treasury Department has authority to issue the regulations necessary to implement the safe harbor. The second, a legislative solution, clarifies the requirements but requires congressional action, which may be difficult to achieve practically. Although eliminating the trader requirement is a better solution than providing a safe harbor, even the safe harbor would significantly clarify the requirements and make it possible and more practical for taxpayers to evaluate whether they qualify to make the election.

Under the proposed safe harbor, if a taxpayer reasonably believes that she will make at least three hundred trades a year (or roughly six trades a week), she will be eligible to make the mark-to-market election, whether or not it turns out that she was engaged in the trade or business of trading securities. Furthermore, in order to capture the courts’ concept that trading should be frequent and continuous, any such safe harbor could require that, in order to be eligible to make the section 475(f) election, a taxpayer must reasonably expect to make at least twelve trades every month. By requiring a taxpayer to reasonably expect to make a set number of monthly and yearly trades, the Treasury Department would eliminate the day trader who expects to be excited for three months and make frequent, if not daily, trades but does not expect to be continuously trading throughout the whole year. If the test is subjective—that is, if a taxpayer must reasonably believe she will make sufficient trades over the course of every year—then it is not essential that she actually make a specific number of trades. 146

It is important that the election be made truly ex ante. It would be theoretically ideal if the deadline to make an election were the day

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146. That said, making a sufficient number of trades would not be immaterial. If the taxpayer made, for example, three sales in each of her first three years, the IRS could reasonably argue that, absent some compelling explanation, her prospective belief was unreasonable. The line would necessarily not be bright. But part of the problem with the currently applied trade-or-business standard is that the number and frequency of trades necessary to meet the requirement are not clear, and even if it were clear that three hundred trades in a year met the standard, a taxpayer would not know in advance (i.e., when she had to make the election) whether she would meet the standard. But somebody who clearly intends to invest for long-term capital appreciation would be unlikely to qualify for such a safe harbor.
prior to the first day of the taxable year for which it would take effect (usually December 31 for individual taxpayers, whereas corporations and other entities may have noncalendar taxable years). But on a practical level, the current requirement—the due date of the electing taxpayer's tax return (without extensions) for the taxable year prior to the year in which the election will take effect—is preferable. Requiring the election to be made before the taxable year begins would cause taxpayers to be entirely indifferent to whether they were taxed at ordinary or capital gains rates, because they would not have any idea how the year would end.  

Because the return on financial instruments that can be marked to market is largely risk based, a taxpayer cannot know on April 15 based on just the first quarter's performance where the market will be at the end of the year. This creates very few, if any, arbitrage possibilities, because it offers taxpayers very little additional certainty. Requiring the election to be made prior to the beginning of the taxable year to which it applies would add a certain amount of complexity to the Code, requiring taxpayers to learn the existence of a new filing date and, potentially, requiring the IRS to create a new form with a new filing deadline. It is simpler to allow taxpayers to make their election on a date when they are already accustomed to dealing with the IRS.

Such a safe harbor would not require a significant learning curve for the IRS to implement and administer. There are already safe harbors in place that rely on taxpayers' subjective intent. For example, the IRS recently provided a safe harbor under section 704(c), which was enacted by Congress in order to prevent taxpayers from taking advantage of the partnership form to shift tax consequences between partners. Under section 704(c), income,
gains, losses, and deductions related to contributed property are to be allocated among partners in a manner that takes into account the difference between the contributing partner’s basis in the property and the property’s fair market value at the time of the contribution. 150 Furthermore, if the property is distributed to someone other than the contributing partner within seven years of its contribution, the contributing partner must recognize any gains or losses she would have recognized had the partnership instead sold the property at its fair market value. 151

These special allocations that take precontribution gains into account are generally made on a property-by-property basis, and built-in gains and losses from different items of contributed property cannot generally be aggregated. 152 The Treasury regulations permit securities partnerships to aggregate built-in gains and losses. 153 The IRS created a safe harbor allowing any partnership that meets the requirements to aggregate its built-in gains and losses. 154 In order to qualify for this safe harbor, among other things, a partnership must reasonably expect[], as of the first day of each taxable year for which the partnership seeks to aggregate under this revenue procedure, that the partnership . . . will make at least 200 trades of qualified financial assets during the taxable year, the aggregate value of which will comprise at least 50% of the book value of the partnership’s assets . . . as of the first day of the taxable year. 155

Provided the partnership has a reasonable ex ante belief that it will make two hundred trades comprising half of its net value, then the partnership is eligible to aggregate its built-in gains and losses. As with a trader in securities and commodities, the partnership cannot know at the beginning of the year whether it will make the specific number of trades. It is, however, in a position to know that it

be indifferent to the gain, and (for a price, at least) may be willing to accommodate the taxpayer’s desire.

151. Id. § 704(c)(1)(B).
153. Id. § 1.704-3(c)(3).
155. Id. § 3.01 (emphasis added).
necessarily intends to make an average of about four trades a week for the following year.

Providing the safe harbor will allow taxpayers certainty that when they make a mark-to-market election, they are eligible to make the election. This certainty will also reduce the disruptive effects of the Code. By knowing in advance that she qualifies to make the election, a taxpayer who desires to be taxed on a mark-to-market basis will not have to settle for realization accounting because she is uncertain whether she will qualify.

C. Enactment of the Safe Harbor
Through Regulatory Means

In many respects, it would be simplest for the safe harbor to be enacted through regulations. The Treasury Department can act without requiring bipartisan agreement and the political give-and-take inherent in the legislative process. There are, however, at least three potentially significant problems with the Treasury’s issuance of safe-harbor regulations allowing a taxpayer to make the election. The first is the question of whether the Treasury Department has the authority to make such regulations, potentially bypassing the legislative and judicial definitions of “trade or business.” Second, taxpayers could attempt to use the safe harbor to be treated as traders in situations to which the safe harbor was not intended to apply. Third, although the safe harbor would provide certainty to taxpayers who meet its criteria, there would still be taxpayers who do not qualify for the safe harbor and have to use the unworkable facts-and-circumstances test in order to determine whether they are eligible to elect mark-to-market accounting.

Regulations under section 475(f) could be either legislative or interpretative, depending on the provenance of the Treasury Department’s authority to promulgate them.\(^{156}\) The secretary of the Treasury Department has general interpretative authority to “prescribe all needful rules and regulations for the enforcement of” the Code.\(^{157}\) Furthermore, the secretary is granted express legislative authority to “prescribe such regulations as may be necessary or

\(^{156}\) See Archer-Daniels-Midland Co. v. United States, 798 F. Supp. 505, 510 (C.D. Ill. 1992) (discussing whether a particular regulation “is a legislative or interpretative regulation”), rev’d, 37 F.3d 321 (7th Cir. 1994).

appropriate to carry out the purposes of [section 475]." 158 On the face of the statute, the requirements a taxpayer must meet in order to be permitted to make a mark-to-market election fit squarely within these legislative regulatory mandates. Not only would the standards to be prescribed seem to be needful under the more general grant of regulatory authority, but they would appear to be necessary to carry out the legislative purpose of permitting a mark-to-market election.

In general, courts will defer to the Treasury Department’s authority to promulgate regulations, especially when the regulations are legislative. 159 However, the Treasury Department’s regulatory authority does not permit it to make regulations that contradict the statute or judicial decisions. 160 The Treasury Department cannot contradict by regulation the unambiguous language of the Code. 161 And, although this Article has argued that the standard that determines whether a taxpayer is engaged in the trade or business of trading securities are unclear and unworkable when applied prior to the beginning of a taxable year (and for that matter are unworkable when applied earlier than the close of the taxable year), Congress created, and the courts approved and explicated, this standard, which is that, in order to make a mark-to-market election under section 475(f), a person must be a trader in securities or commodities and, in order to be treated as a trader, that same person must be engaged in the trade or business of trading securities or commodities. 162 It is not clear that a person who would meet the criteria of the regulatory regime proposed by this Article—or, for that matter, any other ex ante regime the Treasury Department could promulgate—would always qualify as a trader in securities or commodities. Although the IRS created a similar safe harbor so that a partnership may aggregate.
its built-in gains and losses, such aggregation does not have the same long-established history that "trade or business" has, nor is the concept found hundreds of times throughout the Code. "Trade or business," on the other hand, has a long judicial history, is used frequently in various situations in the Code, and has an established meaning. It is not completely clear that the Treasury Department has the authority to promulgate regulations that potentially contradict this long-established history.  

While the Treasury Department can promulgate regulatory safe harbors to allow taxpayers to meet requirements laid out in the Code, it has thus far refrained from offering a regulatory definition of "trade or business." Furthermore, to the extent the proposed safe harbor is inconsistent with current judicial or statutory standards for establishing a trade or business, the Treasury Department would, by promulgating the safe harbor, effectively announce that it was not going to enforce the law as it stands. While the Treasury Department can and has, in certain circumstances, chosen not to enforce a provision of the Code, it is not good tax administration or practice for an executive agency to choose to not enforce the law.

163. On a practical level, the issue would be unlikely to arise judicially. Because the proposed safe harbor is (probably) more liberal than the statutory standard, it would allow more taxpayers to qualify; a taxpayer could not sue alleging that the standard was overly broad. Likewise, if the safe harbor rubbed Congress the wrong way, Congress could change the Code to make clear that, in order to make the election, a taxpayer had to meet the judicial standard for being engaged in a trade or business. This seems unlikely, however, although if Congress were to overrule the Treasury’s safe harbor retroactively (which it would likely only do if it found electing taxpayers abused the provision), there could be detrimental results to some electing traders who failed to qualify under the more stringent standards.

164. E.g., Treas. Reg. § 1.7704-1(e)-(h), (j) (as amended in 1995) (establishing safe harbors under which a partnership interest will not be treated as readily tradable on a secondary market or the substantial equivalent thereof).

165. E.g., I.R.S. Notice 2007-4, 2007-1 C.B. 260. In 2004, as part of the American Jobs Creation Act of 2004, Congress enacted section 470 of the Code, which was intended to crack down on the use of partnerships to transfer taxable income from taxable to foreign or otherwise tax-exempt parties by denying the taxable partners certain deductions in the current year. I.R.C. § 470(a) (2006). The provision was arguably overbroad, however, applying to any partnership with both taxable and tax-exempt partners if the allocation to the tax-exempt partners was inconsistent over the life of the partnership, notably real estate investment partnerships. Chuck O’Toole, Technical Corrections Bill Signed, Exempts Partnership from SILO Law, 88 TAX NOTES TODAY 3 (Jan. 2, 2008). The IRS announced that it would not apply section 470 to certain nonabusive investment partnerships for taxable years beginning before January 1, 2005. I.R.S. Notice 2006-2, 2006-1 C.B. 278. It extended its so-called transition relief first for taxable years beginning before January 1, 2006, id., and again for taxable years beginning before January 1, 2007. I.R.S. Notice 2007-4, 2007-1 C.B. 260. The transition relief, however, was in anticipation of a technical corrections bill that the Treasury Department anticipated would fix the problem, id., rather than because the Treasury Department disagreed with standards contained in the law. In
One difficulty the Treasury Department would have in crafting regulations laying out the requisite level of investment activity in which a person must engage in order to qualify to make the mark-to-market election is in understanding Congress's purpose in proscribing investors from making the election. Congress explained that it expanded the availability of mark-to-market accounting from dealers to electing traders because mark-to-market accounting presented a better reflection of income and reduced the opportunity for manipulation. However, Congress offered no explanation as to why it chose not to offer the same option to investors. Investors may have been precluded from electing mark-to-market accounting because of inertia: investors' losses have traditionally been available to offset only their capital gains plus $3,000 of ordinary income, whereas mark-to-market losses would offset any income the investor had. Although Congress was offering a benefit to traders in securities, it is possible Congress intended to limit that benefit to a narrow, targeted group. On the other hand, it may have simply not occurred to Congress that investors would want to mark their investments in securities and commodities to market (and that the boundary between traders and investors would be unclear and porous). Or there may have been another reason. Without knowing the reason behind Congress's decision to leave investors out of the purview of section 475(f) of the Code, the Treasury Department may not be able to point to legislative history and intent to support its implementation of the safe harbor.

Assuming—as is likely the case—that the Treasury Department has the authority to make such a safe-harbor regulation, however, it may not be in the Treasury Department's best interest to do so. Although the intent to make three hundred trades in the course of a taxable year may be sufficient to allow a taxpayer to elect to mark her securities and commodities to market, it may be insufficient for other purposes, such as permitting a taxpayer's investment expenses to be fully deductible, rather than being subject to the 2 percent floor as miscellaneous itemized deductions. Even if the Treasury Department were to narrowly target the section 475 election in its

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166. See 1997 BLUE BOOK, supra note 33, at 180.
safe harbor, the fact remains that "trade or business" occurs frequently in the Code\textsuperscript{168} and, in at least some contexts, it is advantageous for a taxpayer to be engaged in a trade or business.\textsuperscript{169} Because courts have traditionally read "trade or business" as having a unified definition throughout the Code,\textsuperscript{170} a regulation with a different definition, even if the Treasury Department explicitly limits the definition to the section 475 context, could allow taxpayers to use the new regulatory definition to argue for a more liberal construction of "trade or business" in contexts outside section 475. Even though ultimately this would likely be a losing argument, it would require resources for the issue to be found and litigated. The proposed safe harbor would create certainty for taxpayers but would not be a material revenue raiser for the government.\textsuperscript{171} The costs to the Treasury of creating a more lenient safe harbor, then, may not outweigh the benefit (if any) that would accrue to the government.

Finally, while a regulatory safe harbor offers clarity to taxpayers who meet its requirements, it does nothing to solve the underlying uncertainty. It is possible that a taxpayer who does not reasonably expect to make three hundred trades a year or to make at least twelve trades per month may still be a trader in securities or commodities and would therefore still be required to navigate the courts' trade-or-business requirements ex ante. Furthermore, such a regulatory solution would not even begin to answer the question of what happens to an electing taxpayer who fails to qualify as a trader (especially if the taxpayer did not use the safe harbor) in a postelection taxable year. While, for a subset of taxpayers, a regulatory solution disposes of the question of how a taxpayer can know in advance whether she is a trader, the question ultimately remains on the table. Still, "a regulation need not be the only, or even the best, construction of the statute it purports to implement."\textsuperscript{172}

\begin{itemize}
  \item \textsuperscript{168} See Boyle, supra note 41, at 737.
  \item \textsuperscript{169} Id.
  \item \textsuperscript{170} See deKrause v. Comm'r, 33 T.C.M. (CCH) 1362 (1974).
  \item \textsuperscript{171} While it is true that income would all be taxed at ordinary rates, losses would be fully deductible at ordinary rates against any income, not just against capital gains plus $3,000 of ordinary income for individuals. Permitting more taxpayers to make a mark-to-market election would likely result in a different amount of revenue to the government, but such a difference should not be material, and it is not entirely clear whether the government would raise more or less revenue if it permitted fewer taxpayers to make the election.
  \item \textsuperscript{172} Robinson, 119 T.C. at 69.
\end{itemize}
Even if the regulatory implementation of the safe harbor is an imperfect construction of Congress's intent, offering certainty to electing traders is a compelling reason to produce these regulations.

**D. Enactment of the Safe Harbor**

*Through Legislative Means*

In contrast to the Treasury Department, Congress clearly has the authority to clarify the requirements a taxpayer must meet in order to mark her securities to market. Congress is not constrained by the existing legislation, because it can rewrite that legislation. In rewriting the legislation, moreover, it could remove the trade-or-business requirement from the requirements to make an election and thus remove the election from extant judicial precedent. The new legislation could be as simple as expressly granting the Treasury Department the authority to define the criteria a taxpayer must meet in order to elect mark-to-market treatment or as complicated as a complete rewriting of the provisions of section 475(f).

Simply granting the Treasury Department regulatory authority, however, is most likely insufficient to solve the problems for some of the same reasons that the Treasury Department's writing of the safe harbor regulations without such clear authority is problematic. The express grant would solve the question of whether the Treasury Department was authorized to create the safe harbor, but as long as the Code uses the term "trader," the full force of law surrounding "trade or business" is implicated. Even with a mandate that encompassed only defining "trader" for purposes of the mark-to-market election, taxpayers could argue in other areas in which it was advantageous to be engaged in a trade or business that the section 475(f) safe harbor was analogous to and, indeed, the clearest statement available of the criteria required to be engaged in a trade or business. 173

A better solution, then, would be to rewrite the provision in a way that excises any implication of a trade-or-business requirement. This could be as simple as changing the terminology so that, for

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173. Where the Code is ambiguous about the proper tax treatment of a taxpayer or transaction, taxpayers and the IRS frequently look to analogous situations or transactions for guidance as to the appropriate tax treatment. *See, e.g.*, I.R.S. Notice 2004-52, 2004-32 C.B. 168 (asking for comments on what current tax regime was most analogous to credit default swaps and therefore most appropriate to apply to this type of transaction).
example, rather than permitting a “trader” to elect, section 475(f) allows a “qualified short-term investor” to make the mark-to-market election.\textsuperscript{174} By making a clean break from the term “trader,” or anything else that indicates that the standard is tied to the rules for being engaged in a trade or business, there is no danger of the new standard bleeding over into inappropriate or inapposite uses.

Creating a new taxonomy in the Code, of course, may raise its own problems. First the new term\textsuperscript{175} must be defined. Congress may choose to do this in the Code, or it may delegate such authority to the Treasury Department. If, however, it delegates the authority to the Treasury Department, even if Congress suggests the contours of the definition in the legislative history or in the Code itself, the definition will be unclear until the Treasury Department promulgates and

\textsuperscript{174} In addition, in making such a change, it would probably be valuable for Congress to include language in the legislative history indicating that the change was intended to make a complete break with the trade-or-business standard.

\textsuperscript{175} While this Article proposes “qualified short-term investor,” a phrase descriptive of the type of taxpayer that Congress seems to want to permit to make a mark-to-market election, there is nothing special about this phrase such that it is the terminology that Congress must use to clarify the criteria for the election. The most important point to keep in mind, however, is that, in order to avoid the problems associated with the term “trader,” the new term needs to be a term otherwise unused in the Code.
finalizes the regulations. And the Treasury Department's production of regulations is not always timely.

If Congress were to define "qualified short-term investor," it would be advisable to trace the contours discussed above. Because the goals of providing a safe harbor for mark-to-market elections ultimately include providing clarity to taxpayers prior to their entry into any transaction, creating an incentive for taxpayers to pay taxes based on a closer approximation of their Haig-Simons income, and facilitating compliance with the tax law, a subjective bright-line rule would be most apposite. If Congress were to require that a qualified short-term investor reasonably believe that she would engage in at least three hundred securities or commodities transaction in a year, with at least twelve in each month, the election would remain available only to those who would, after the close of the taxable year, likely be able to claim for other purposes that they had been engaged in the trade or business of trading in securities or commodities. If, on the other hand, Congress were to give the Treasury Department the

176. For example, the classification of an instrument as debt or as equity creates significant and distinct tax consequences. However, both the Supreme Court and Congress have consistently declined to clearly define the line dividing debt and equity. William T. Plumb, Jr., The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 TAX L. REV. 369, 369–70 (1971). In 1969, Congress enacted I.R.C. section 385, id. at 370 n.10, which authorized the Treasury Department to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness." I.R.C. § 385(a) (2006). Along with granting the Treasury Department authority to issue regulations, Congress listed certain factors that the Treasury Department should take into account in the regulations to determining whether an instrument was debt or equity. Id. § 385(b). The Treasury Department issued the debt-equity regulations in 1980, which were to become effective for corporate interests created after April 30, 1981, in order to provide time for taxpayers to become comfortable with the new rules. T.D. 7747, 1981-1 C.B. 141. The effective date was extended a number of times, however, with changes to the regulations made each time. T.D. 7822, 1982-2 C.B. 84; T.D. 7801, 1982-1 C.B. 60; T.D. 7774, 1981-1 C.B. 168. Finally, in 1983, the regulations under section 385 were withdrawn, T.D. 7920, 1983-2 C.B. 69, and as of the date of this Article—almost forty years since section 385(a) was enacted and more than a quarter century after the Treasury Department attempted to promulgate regulations for the first time—no debt-equity regulations have been enacted. In spite of what guidance exists in section 385, taxpayers still look to the ad hoc judicially determined factors in order to determine whether an instrument is debt or equity. See, e.g., Flint Indus. Inc. v. Comm'r, 82 T.C.M. (CCH) 778 (2001) (“We proceed to examine the advances under the traditional multifactor approach.”).

177. While the possible delay between the need for regulations and their enactment is perhaps most starkly demonstrated in the currently approximately forty-year wait for regulations under section 385, that is not the sole regulatory delay; even when the Treasury Department acknowledges the need for regulations, it does not always move promptly. For example, although it recognized in 2004 that taxpayers needed guidance on the appropriate tax treatment of credit default swaps, I.R.S. Notice 2004-52, C.B. 168, it has still not provided any guidance. See Brunson, supra note 16, at 2–4.

178. See supra Part VI.B.
authority to issue regulations defining "qualified short-term investor," Congress could nonetheless give the Treasury Department an outline of what it intended those regulations to look like. 179

Whether Congress decides to define "qualified short-term investor" (or whatever other term it chooses to use) itself or assign the Treasury Department to define the term, however, introducing a new test to the Code will increase its complexity. Although the definition of "trader" lacks clarity and is unworkable except in hindsight, the dealer-trader-investor taxonomy nonetheless plays a significant part in several Code sections. 180 A new Code provision, based around a new definition, changes existing underlying assumptions and requires taxpayers and their advisors (as well as the IRS and the courts) to learn the organizational schema and determine how to most aptly apply the schema in their ordinary course of business. Nevertheless, the benefits of providing taxpayers with certainty in electing mark-to-market accounting outweighs the potential detriment of added complexity.

VII. CONCLUSION

Although the election for traders to mark their positions in securities and commodities to market was introduced into the Code in 1997, 181 there has been very little analysis of whether it works as

179. It is not uncommon in the Code for Congress to give the secretary of the Treasury Department authority to issue regulations while, at the same time, telling the secretary roughly what the regulations should say. For example, section 1276 of the Code provides rules for the treatment of accrued market discount on the disposition of a debt instrument. The section ends:

(d) Special rules

Under regulations prescribed by the Secretary—

(1) rules similar to the rules of subsection (b) of section 1245 shall apply for purposes of this section; except that—

(A) paragraph (1) of such subsection shall not apply,

(B) an exchange qualifying under section 354(a), 355(a), or 356(a) (determined without regard to subsection (a) of this section) shall be treated as an exchange described in paragraph (3) of such subsection, and

(C) paragraph (3) of section 1245(b) shall be applied as if it did not contain a reference to section 351, and

(2) appropriate adjustments shall be made to the basis of any property to reflect gain recognized under subsection (a).

I.R.C. § 1276(d) (2006). Although the Treasury Department is tasked with writing the regulations, the Code makes clear what contours those regulations are to follow.

180. See Boyle, supra note 41, at 737.

181. See 1997 BLUE BOOK, supra note 33, at 180.
well as it should. What literature has been written about section 475(f), however, universally acknowledges the difficulties of knowing whether an electing party qualifies as being engaged in the trade or business of trading in securities, a prerequisite to making the election. The problems are compounded by the courts' application of a stringent set of trade-or-business requirements to investors who have attempted to make a late election in order to take advantage of losses that they incurred but failed to realize, rightfully blocking such abusive behavior but making the standards for a timely election even more difficult for taxpayers to meet.

This Article has added to the critical exploration of section 475(f) of the Code by demonstrating that the standard for determining whether a person is engaged in a trade or business, although not completely clear in any event, works well enough when it is invoked after the taxable year to which it applies (for example, in order to determine whether expenses are fully deductible or are miscellaneous itemized deductions). There is no reason why a taxpayer's status cannot be different from one year to another.

It has also demonstrated that a taxpayer cannot have the information she needs to make such an evaluation at any time materially before the end of the taxable year. Although she may intend to make frequent trades, capturing short-term movements in the values of securities and commodities, she cannot know whether she will follow that trading pattern or not. That is, it is impossible for a taxpayer to know, at the time she must make the election, whether she qualifies to make it.

This Article has also demonstrated that, because of the current uncertainty surrounding who may make a mark-to-market election, because of the desirability of bringing taxable income in line with Haig-Simons income, and the limited downside to liberalizing the availability of the election, the section 475(f) election should be available to all taxpayers. Even if the requirements for making a

182. See supra Part III.

183. In theory, there is no reason why she could not know sometime late in the year. By December, if her trading activities have qualified up to that point as a trade or business, chances are that, even if she fails to trade in December, she will have met the requirements of engaging in the trade or business of trading securities for the year. However, the year is also virtually over by that time, and the investor very likely has some idea whether her net positions will be gains or losses, and such a late deadline for making the election would not materially prevent her from taking advantage of her foreknowledge in deciding whether to make the election.
mark-to-market election are not liberalized, however, it is necessary that, at a minimum, a safe harbor be provided under which a taxpayer can know ex ante whether she qualifies to make the mark-to-market election.

Only Congress can eliminate the trade-or-business requirement, but short of its elimination, either the Treasury Department or Congress can create a subjective safe harbor, either defining what it means to be a trader for purposes of the election or taking the prerequisites out of the realm of "trade or business" altogether. Either solution has potential downsides. Even with the potential downsides, though, the upside potential of the proposed safe harbor (i.e., providing taxpayers with certainty that they qualify to make a mark-to-market election) is a net improvement over the uncertainty that currently underlies section 475(f).

Although theoretically it would be preferable for Congress to act to solve the problem, realistically, Congress may not be motivated to make such a change. The Treasury Department, on the other hand, routinely creates safe harbors and makes other decisions about the administration of the Code. While it is not altogether clear that the Treasury Department has the authority to create a safe harbor as outlined in this Article, it is unlikely that any taxpayer would have standing to challenge the requirements because the safe harbor would ease them. Furthermore, the Treasury Department can and does regularly solicit input from taxpayers who will be affected by new regulations. It certainly could and would receive taxpayer comments on any safe harbor it intended to create, further assuring that the safe harbor would meet the needs of the relevant community of investors in securities and commodities.

While neither eliminating the trader requirement altogether nor establishing the safe harbor proposed by this Article is a panacea for all the troubles with the taxation of investment income, either solution would solve significant problems surrounding the mark-to-market election. The most notable of these is the impossibility of a taxpayer knowing, at the time she is required to make the election, whether she will be a trader in securities and therefore be qualified to make the election. This also creates certain problems by adding an

184. See supra Parts VI.C–D.
as-yet-unknown regime to the Code—one without a history on which taxpayers can draw. The safe harbor, however, is not terribly complex and can be relatively easy to describe in the Code itself or in simple regulations that the Treasury Department could write and release reasonably quickly. On a net basis, however, the benefits of either permitting any taxpayer, without limitation, to elect mark-to-market accounting or implementing the proposed safe harbor outweigh the detriments because they make it possible for taxpayers to know that they are qualified, and taxpayers can confidently elect to mark their securities positions to market.

It is beneficial to provide certainty to taxpayers. Mark-to-market accounting better reflects taxpayers’ Haig-Simons income and prevents tax arbitrage using the timing option, which prompts taxpayers to accelerate their deductions and defer the recognition of taxable income. Although taxpayers do not always have access to information or liquid capital to make mark-to-market accounting a practical choice, where taxpayers are able and willing to choose mark-to-market accounting, the Code should make it possible and convenient to do so. This Article provides a step toward making mark-to-market accounting a more realistic possibility for more taxpayers.