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Internal Revenue Service Allows Hedge Funds to Automatically Change from Mark-to-Market Method for Tax Purposes

In a recent revenue procedure, Revenue Procedure 2015–14, the Internal Revenue Service (IRS) now permits traders in securities or commodities that elected mark-to-market accounting to **automatically** change from a marking method to a realization method. Previously, traders needed to obtain IRS consent to change from the mark-to-market method. A calendar year partnership has until **April 15** of this year to revoke its section 475(f) election for 2015.

Background

Traders in securities or commodities were first granted the ability to elect mark-to-market accounting for tax purposes pursuant to IRC section 475(f), enacted in 1997[1]. The statute provides that once the election is made, it applies to the taxable year for which made and to all subsequent taxable years, and may only be revoked with the consent of the IRS.

Revenue Procedure 99–17 provides special rules that force traders to elect mark-to-market accounting early in the tax year to minimize hindsight in making the election. In general, taxpayers make the election for the current year by attaching a statement to the timely filed original tax return for the immediately preceding tax year, without extension, or to the timely filed extension for the immediately preceding year. Thus, a calendar year partnership that wants to make a section 475(f) election for 2015 must make the election by April 15 of this year.

A trader that elects to change its method to the mark-to-market method can make the change “automatically,” that is, without IRS consent. If the election results in a change in method of accounting, the change is effected through a section 481(a) adjustment under Rev. Proc. 99–17. If the election results in a positive adjustment to taxable income, then the positive adjustment is spread over four years. A negative adjustment is taken all in the current year.

Many actively traded hedge funds have made the IRC section 475(f) election to eliminate the complexities involved in complying with the wash sale, straddle and constructive sale rules. The trade-off for making the election is that all trading gains and losses are treated as ordinary regardless of the taxpayer’s holding period for the securities or commodities, and no deferral of gain is possible.

Once a trader makes the IRC section 475(f) election, the trader needs to obtain IRS consent to revoke the election. We have represented clients before the IRS who filed method change requests to change from the mark-to-market method. The IRS granted those method change requests, but required taxpayers to implement the method change using a “final mark” (rather than through a section 481(a) adjustment).

New Guidance

Revenue Procedure 2015–14 now allows taxpayers that had previously made a mark-to-market election under IRC section 475(f) to automatically change from that method to a realization method. The due date for revoking the section 475(f) election mirrors the due date for making the section 475(f) election, that is, the election must be

[1] The determination of whether a taxpayer is a trader as opposed to investor in securities and/or commodities is beyond the scope of this alert. Investors cannot make the IRC section 475(f) election.

revoked by the due date of the trader's original tax return for the immediately preceding tax year **(without extension).**

Revocation is achieved by attaching a "notification statement" to the taxpayer's timely filed original federal income tax return for the tax year immediately preceding the election year or to the extension request for the immediately preceding tax year. The taxpayer must also attach the notification statement to the Form 3115, Application for Change of Accounting Method, which is filed with the tax return for the year of change. Once a taxpayer revokes a section 475(f) election, it cannot make another automatic method change back to the mark-to-market method for a period of five years (although a "manual" accounting method change may be requested, subject to IRS consent).

The automatic method change is effected through a special "cut-off" method. Specifically:

- The taxpayer makes a final mark of all securities or commodities subject to the method change request on the last business day of the preceding tax year, and ordinary gain or loss is recognized
- Proper adjustment is made in the amount of any gain or loss subsequently realized to take into account the final mark
- Any change in value occurring after the beginning of the year of change is taken into account using a realization method, and presumably results in capital gain or loss.

Contacts

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