Traders in virtual currency might want to currently deduct their trading losses and avoid application of the capital loss limitations that apply to traders. To do so, they would want to elect into the special tax rules found at I.R.C. § 475(f) for electing traders in securities or commodities. Taxpayers who qualify for and elect into either of these trader elections would mark their virtual currency gains and losses to market at ordinary income rates.

Electing into I.R.C. § 475 means taxpayers would receive ordinary income and loss on positions closed out during the year and on all positions open at the end of the year. In exchange for ordinary tax treatment and accelerating tax on open positions, electing traders can report their losses without applying capital loss limitations, the tax wash sales rule at I.R.C. § 1091 or the tax straddle rules at I.R.C. § 1092.

This article addresses the analysis that taxpayers who hold virtual currency positions need to make to evaluate whether they are eligible for the I.R.C. § 475(f) election as a trader in securities or a trader in commodities (collectively, trader elections). For a discussion of the tax wash sales rule, see McDermott’s article, “When Virtual Currency Positions Are Subject to the Wash Sales Rule.” For a discussion of the tax straddle rules, see McDermott’s article, “When Virtual
Currency Positions Are Subject the Straddle Rules.”

The trader elections depend on meeting two requirements. First, the taxpayer’s virtual currency transactions must qualify for tax purposes as “securities” to make the securities trader election (I.R.C § 475(f)(1)) or as “commodities” to make the commodities trader election (I.R.C § 475(f)(2)). Second, assuming the virtual currency transactions meet the I.R.C. § 475 definitions of “securities” or “commodities,” the taxpayer’s trading activities must rise to the level of active trading under applicable case law.

Virtual Currency Positions as Securities or Commodities

To make a valid trader election, virtual currency traders must determine if the particular virtual currency positions they trade qualify as securities or commodities.

Securities Defined

A “security” is broadly defined in I.R.C. § 475 to include any (1) share of stock, (2) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) debt interest (I.R.C § 475(c)(2)), and (4) interest rate, currency, or equity “notional principal contracts” (such as swaps, caps and floors).

A security also includes at item (5) any evidence of any interest in, or any derivative financial instrument in, any currency or security within the terms of items (1) through (4), including options, forwards, short positions and similar financial instruments. Further, it includes at item (6) a “position” that is not itself a security under items (1) through (5) but the position is a “hedge” of such a position and it is clearly identified as a hedge with respect to that security (I.R.C § 475(c)(2)(F)(ii)). There is no requirement that the item, itself, must be “actively traded.” (Although the term “security” does not include section 1256 contracts, such contracts, as defined in I.R.C. §1256(g), can be treated as securities to the extent they qualify as hedges under item (6). For a discussion of section 1256 contracts, see McDermott’s article, “Special Tax Rules Apply to Bitcoin Futures and Options and Might Apply to Positions in Ether and Other Virtual Currencies in the Future.”)

Because the items that qualify as “securities” are carefully enumerated in I.R.C. § 475(c)(2), it is not likely that the IRS will try to treat other items as “securities” for purposes of I.R.C. § 475 just because they are treated as securities for federal securities law purposes. It is likely that the IRS will only treat items as securities if the items clearly fit into the items that are enumerated. This means that taxpayers who enter into positions in virtual currency need to carefully consider item 5 (set out above) to see whether their positions might meet the definition of that item. For a discussion of the tax definitions of securities, see McDermott’s article, “Can a Virtual Currency Position Be Treated as a Security for Tax Purposes?”

Commodities Defined

The term “commodity” is broadly defined in I.R.C. § 475 to include any commodity that is actively traded for purposes of the straddle rules in I.R.C. § 1092(d)(1). (I.R.C. § 475(c)(2)(A). Treas. Reg. § 1.1092(d)-1(c)(1) provides that the actively traded
standard requires an established financial market, ranging from an interdealer market to an established financial market.) For a discussion of the straddle rules, see McDermott’s article, “When Virtual Currency Positions are Subject to the Straddle Rules.” Commodities include physical commodities, derivative instruments in any commodity and evidences of interests in any commodity. Unlike the I.R.C. § 475 statutorily enumerated definitions of a “security,” which term specifically excludes section 1256 contracts, the term commodity specifically includes section 1256 contracts, making them subject to I.R.C. § 475 rather than I.R.C. § 1256. For a discussion of I.R.C. § 1256, see McDermott’s article, “Special Tax Rules Apply to Bitcoin Futures and Options and Might Apply to Positions in Ether and Other Virtual Currencies in the Future.” As with the definition of security, the commodity definition includes any position that is not itself a commodity if it serves as a hedge with respect to a commodity.

Although not free from doubt, the IRS “has historically deferred to the Commodity Futures Trading Commission (CFTC) and its predecessor agencies as to what constitutes a ‘commodity’ for US federal tax purposes” (NYBA Tax Section, “Report on the Taxation of Cryptocurrency,” January 26, 2020; see also Rev. Rul. 73-158, 1973-1 C.B. 337). The word “commodities” is used in I.R.C. § 864(b)(2)(B) in its ordinary financial sense and includes all products that are traded in and listed on commodity exchanges located in the United States. Furthermore, the word “commodities” includes actual commodities and commodity futures contracts. This makes it possible that I.R.C. § 475 will include actively traded items that are treated as commodities under the federal commodity laws. For a discussion of the tax definitions of commodities, see McDermott’s article, “Can a Virtual Currency Position Be Treated as a Commodity for Tax Purposes?”

**Securities or Commodities?**

Most virtual currencies, in and of themselves, are more likely to be taxed under I.R.C. § 475 as commodities rather than as securities. With that said, there is no definitive answer one way or the other as to whether certain virtual currency positions can be treated as securities or commodities. There are good arguments that certain virtual currency positions are securities and that other actively traded virtual currency positions are commodities.

This leads us to the question of which of the two trader elections a virtual currency trader might consider making for appropriate virtual currencies and positions in those virtual currencies. Which virtual currency positions are securities, and which ones are commodities? This “commodity or security” definitional conundrum might not ultimately matter if the IRS is willing to allow taxpayers who believe they might fall into both categories to elect under both the securities trader and the commodities trader provisions. Although there is no specific authority for making such a dual election, the author is prepared to explore this possibility with the IRS in appropriate client situations.

**Taxpayers Must be Active Traders**

If a particular virtual currency qualifies as a security or a commodity, electing traders must also meet another requirement: their activities must be substantial and
carried on in a continuous and regular basis. Trader tax status is a fact-based determination, subject to the taxpayer’s actual facts and circumstances.

The trader election will be effective only if the electing taxpayer is a trader in either securities or commodities. (For the definition of “trader” to be applied for these purposes, see Chen v. Commissioner, 87 T.C.M. (CCH) 1388 (T.C. 2004); Arberg v. Commissioner, 94 T.C.M. (CCH) 215 (T.C. 2007); and Holsinger v. Commissioner, 96 T.C.M. (CCH) 85 (T.C. 2008). See also Bielfeldt v. Commissioner, 231 F.3d 1035 (7th Cir. 2000), describing the difference between a trader and a dealer, noting that a “dealer’s income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader’s income is based not on any service he provides but rather on fluctuations in the market value of the securities or other assets that he transacts in.”) The courts essentially apply a merchant analogy to determine whether a taxpayer sells securities to customers (see Bradford v. United States, 444 F.2d 1133 (Ct. Cl. 1971) [71-2 U.S.T.C. 9542], and Kemon v. Commissioner, 16 T.C. 1026 (1951).

Traders must profit from daily market movements, not from dividends, interest, or capital appreciation. IRS Publication 550 identifies some factors to consider, including the length of holding periods, frequency of trades, whether the taxpayer is engaged in the activity to produce a principal source of income, and the amount of time the taxpayer devotes to the trading activity. (See also Paoli v. Commissioner, 54 T.C.M. (CCH) 1574, 1578 (1988), and Chen v. Commissioner, 87 T.C.M. (CCH) 1388 (2004).) The phrase “trade or business” is not defined in the Code or Treasury regulations. Various factors are considered, with no one factor dispositive. Elements of a trade or business include (1) activities that occupy “the time, attention and labor” of the taxpayer for the purpose of “a livelihood or profit”; (2) the continuity and regularity of the taxpayer’s activities; and (3) a profit motive. In Commissioner v. Groetzinger, the US Supreme Court held that a professional gambler could be in a “trade or business” if the gambler devotes his full-time activity to gambling and it was his intended livelihood source. In this situation, his activity should be regarded as a trade or business “just as any other readily accepted activity”(480 U.S. 23 (1987)).

**Trade or Business Expenses**

Traders’ trade or business expenses are deductible under I.R.C. §162. Deductible expenses can include office rental, other office expenses, salaries, computer equipment, software programs, Internet access fees and utilities.

**Application of Trader Elections**

Electing traders receive ordinary gain or loss for their securities and commodities positions that are held in connection with their business of being securities or commodities traders. Because taxes are paid on recognized and unrecognized gains and losses, electing traders can be required to pay tax on gains that, in fact, they may never actually realize. If they continue to hold contracts that were marked-to-market at year end, gains and losses realized in a subsequent tax year are adjusted to reflect gains and losses taken into account in the preceding taxable year. The
requirement to mark open positions to market can, therefore, distort income and cause economic hardship if gains that were reported in the first year do not materialize in a subsequent tax year.

In evaluating the costs of accelerating gains under the mark-to-market regime, electing traders must also evaluate the fact they can deduct their trading losses against trading profits and their ordinary income from other sources. Losses of electing traders are not limited to the standard $3,000 capital losses amount.

**Elections and Revocations**

Elections into I.R.C. § 475 and revocations of elections are subject to detailed reporting and filing requirements. Late elections or revocations are not generally allowed, except in unusual and compelling circumstances that comply with Treasury regulations and IRS guidance.

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Taxpayers who are interested in exploring an election into I.R.C. § 475 should consult with their tax advisors about the availability of the election and the federal and state tax implications of making such an election. Many states do not follow federal tax returns in computing state taxes.

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