ALERTS

Tax Reminder: Deadline to Make a Section 475(f) Election for Most Calendar Year Partnership Funds Is Monday, March 16

March 15, 2020

Alternative investment funds that are "traders" may be considering whether or not to make a Section 475(f) election in light of recent market volatility. Investment funds treated as partnerships have until ***March 16, 2020****, to timely file this election for the 2020 tax year.*

For those investment funds considering whether or not the Section 475(f) election is right for them, a brief description of some of the effects of this election are described herein.

Alternative investment funds whose trading activity rises to the level of being a "trader" rather than an "investor" are eligible to elect to "mark-to-market" their securities and/or commodities positions held in connection with such trade or business under Section 475(f) of the U.S. Internal Revenue Code of 1986, as amended ("Code"). Securities traders may make the election under Section 475(f)(1) of the Code, while commodities traders may make the election under Section 475(f)(2) of the Code; there is no requirement that traders make both elections.

As further discussed below, the mark-to-market election for the 2020 tax year for most trading funds who commenced operations before 2020 and are partnerships for U.S. federal tax purposes is due Monday, March 16.[1] **Funds who are considering whether to make this election should consult with their tax advisers and tax return preparers in order to review the tax characteristics of the**

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assets in their portfolio and coordinate the making of the election in light of their own particular circumstances, taking into account that the election will pertain to the tax treatment of the fund's activities through the end of the tax year. Certain considerations in making the election are discussed below.

A Section 475(f)(1) or (f)(2) election causes most, if not all, of such an electing fund's securities positions or commodities positions, respectively, to be deemed sold for U.S. federal income tax purposes at the end of the fund's taxable year, and the gain or loss from actual sales during the year and deemed sales occurring at the end of the year would generally be treated as ordinary income or loss, instead of capital gain or loss.[2] Historic gains would be included in income under Section 481(a) of the Code, typically over a four-year period beginning with the year of the election, while historic losses would generally be included for the year of the election.

Under general U.S. federal income tax principles, capital losses may not offset ordinary income; rather, a net capital loss recognized in a year is carried forward to be used against capital gains, if any, of the taxpayer in future years.[3] As a result, if a fund is holding ordinary income-generating positions (e.g., interest-bearing debt instruments and certain notional principal contracts) but anticipates material depreciation in its net asset value for the calendar year, the election might prevent the recognition of taxable income that could be substantially out of proportion with the fund's economic return. Please note, however, that accelerating and/or converting any losses to ordinary losses as a result of a Section 475(f) election may cause certain limitations to apply with respect to the use of such losses. For example, a noncorporate taxpayer may be limited in its ability to deduct trade or business losses, including losses passed through as a result of a Section 475(f) election, against investment income.[4]

Such an election also turns off the "straddle" rule, which generally defers certain losses, and the "wash sale" rule, which otherwise generally suspends a taxpayer's loss from the sale of a position if the taxpayer acquired or acquires a substantially identical position within the 30 days preceding or following such loss transaction. Even a fund that does not anticipate the ordinary income/capital loss mismatch described above, such as certain equity funds, may wish to consider the election if it intends to avoid the straddle rules, the wash sale rules and match taxable income or loss with economic returns. Again, the election would apply to *all*

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positions for the calendar year and not solely those held or disposed of during the first quarter of the year.

The deadline for making a mark-to-market tax election for a tax year is generally the due date (without extension) for filing the taxpayer's U.S. federal tax return for the preceding year.[5] *Thus, for an election for a partnership to be effective for the 2020 tax year, the election must be made by Monday, March 16, 2020,* by attaching a statement containing such election to the fund's extension request for filing its 2019 U.S. federal tax return (IRS Form 7004) or to the 2019 U.S. federal tax return itself if the return is filed by March 16, 2020.[6] An individual or a corporation with a calendar year tax year would have until April 15, 2020 to make such this election.

The Internal Revenue Service has not indicated whether it will grant leniency to taxpayers regarding these elections in light of the market fluctuations resulting from the COVID-19 pandemic. If an investment fund wants to be sure the mark-to-market election is effective for the 2020 tax year, it should take action by March 16, 2020.

Importantly, a Section 475(f) election would be effective for all of 2020 and any future tax year, but a partnership may elect to revoke the election for a future year by filing a notice by the due date for the preceding year's return.[7] For example, if a taxpayer wanted to mark-to-market its positions only for the 2020 tax year, it could revoke the election for its 2021 tax year, by electing no later than March 15, 2021 (i.e., the due date for filing the 2020 tax return without extension). No subsequent mark-to-market election could be made without getting IRS consent for five years beginning with the year of revocation.

Please contact your attorney at Schulte Roth & Zabel at your earliest convenience if you wish to discuss this notice.

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[1] While the vast majority of taxpayers to whom this election is relevant in the alternative investment fund space are partnerships for U.S. federal tax purposes, such as trading funds that are "domestic funds" which admit taxable U.S. investors and most master funds, the election may also be made by other types of taxpayers who are considered to be traders in securities or commodities for U.S. federal income tax purposes.

[2] The election would generally not affect the lower tax rate applicable to "qualified dividends" or apply to non-hedging Section 1256 contracts,

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unless in the latter case the Section 475(f)(2) election is made by a commodities trader and the Section 1256 contract is a commodity.

[3] Individuals may use $3,000 of capital losses to offset ordinary income.

[4] See Section 461(l) of the Code.

[5] For new partnerships, the election must be made by a notation in their books and records, no later than two months and 15 days after their first tax year begins.

[6] The specific instructions for making the election are contained in IRS Revenue Procedure 1999-14, Section 5.04 and IRS Revenue Procedure 2019-43, Section 24.01.

[7] The instructions for making such a revocation are provided in IRS Revenue Procedure 2019-43, Section 24.02.

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