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Taxation of Cryptocurrencies: In Anticipation of the IRS's Call

by Sahel Ahyaie Assar[*]

I. INTRODUCTION

Before the rise of the Foreign Account Tax Compliance Act (FATCA) became a ''thing'' in the early 2000s, there were many fishing expeditions by the Internal Revenue Service into learning the methods Americans used to hold funds offshore — sometimes engaging in tax evasion. I make the distinction because not all Americans with funds overseas have a guilty mind. Some just prefer to diversify or are part of an international family structure. Nevertheless, the methods learned by the Department of Justice and the IRS eventually led to Congress's enactment of FATCA in 2010. With the rise of cryptocurrencies and virtual currencies, the IRS is keen to learn more about the application and uses of these virtual currencies and is once again flexing the agency's investigative and enforcement muscles to track down non-compliant taxpayers.

The United States is not alone in trying to understand the use and taxation of these tech-like financial instruments. On July 21–22, 2018, the G-20 finance ministers and central bank governors met in Buenos Aires, Argentina to discuss a number of international tax topics, including among them the expansion of cryptocurrencies and the need for government regulatory oversight. More specifically, the group restated its previous position for Financial Action Task Force (FATF) to clarify the standards applicable to crypto-assets. France, New Zealand, the U.K., Israel, and a host of other countries are bolstering their understanding of virtual currencies as well as their legal and tax consequences, respectively. The Organization for Economic Cooperation and Development (OECD), for example, has initiated a working group to assess cryptocurrencies and its impact on corruption and fraudulent activities.[1] Similarly, businesses are ramping up their use of cryptocurrencies. For example, Facebook's announcement that it plans to issue its own crypto-based payment system (referred to as ''Project Libra'')[2] lends credibility to the fact that cryptocurrencies are here to stay and the government is becoming more aware of the need to understand how they work and where the risks for non-compliance may be.

Against this background, the ''noise'' we are hearing from the IRS and Congress[3] after a sluggish start around understanding the activities surrounding cryptocurrency enforcement is akin to the pre-FATCA investigative mood. On July 2, 2018, the IRS announced a campaign to better understand virtual cur-

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[1] *See* OECD, *Cryptocurrencies: Opportunities, Risks and Challenges for Anti-Corruption Compliance Systems*, available at http://www.oecd.org/corruption/integrity-forum/academic-papers/Ciupa-Katarzyna-cryptocurrencies.pdf (Mar. 2019); *see also* OECD, *How to Deal with Bitcoin and Other Cryptocurrencies in the System of National Accounts* (Oct. 29, 2018), available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=COM/SDD/DAF(2018)1&docLanguage=En.

[2] *See Facebook Unveils Cryptocurrency Libra in Bid to Reshape Finance*, Wall St. J. (June 18, 2019), available at https://wwwwsj.com/articles/facebook-unveils-crypto-wallet-based-on-currency-libra-11560850141.

[3] *See* Congressional Letter to Charles P. Rettig, Commissioner (Apr. 11, 2019), available at http://src.bna.com/HhY.

rencies and enforce individual compliance.[4] One year later, on July 26, 2019, to educate and persuade taxpayers with unreported or unpaid taxes relating to cryptocurrency transactions to voluntarily comply with the law, the IRS issued a news release titled ''Reporting Virtual Currency Transactions.''[5] The release provides three sample letters (IRS Letter 6173, IRS Letter 6174, and IRS Letter 6174-A, together the ''IRS Letters'') to prepare taxpayers to fully understand their U.S. federal tax and reporting obligations. The opening sentence in the IRS Letters alone is reminiscent of FATCA-like inquiries:

> *[W]e have information that you have or had one or more accounts containing virtual currency and may not have met your U.S. tax filing and reporting requirements for transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.*[6]

According to the news release, by the end of August 2019, the IRS will have sent more than 10,000 letters to taxpayers it suspects may have unreported income during tax years 2013 through 2017 relating to transactions using cryptocurrencies. Taxpayers are warned to actively report their holdings, correct any previous erroneous reporting and calculate the tax.[7]

If history is prologue, taxpayers should seriously start (if they haven't already) reviewing their transactions using cryptocurrencies and assess early-on (i.e., before the IRS contacts them) what are the correct U.S. federal income tax consequences to transactions they have concluded using cryptocurrencies.

To help bridge a gap between the available government guidance and what remains open and subject to interpretation — ergo, causing confusion for taxpayers' compliance initiatives — this article provides a general overview of the U.S. federal income tax consequences and reporting requirements relating to transactions involving cryptocurrencies.

II. BRIEF HISTORY OF THE EVOLUTION OF CRYPTOCURRENCIES AND KEY DEFINITIONS

Cryptocurrency (crypto), also referred to as virtual currency, has been the subject of growing interest by government regulators, including in the U.S., the IRS, the Department of Treasury, the Securities and Exchange Commission, the DOJ and the Federal Bureau of Investigation, among others. Significant market activity, volatility, and investor interest in the crypto space has sparked important interest to evaluate the value and use of these types of assets, including the federal and state taxation of cryptocurrencies.

A cryptocurrency (e.g., bitcoin) is an electronic payment system that is based on cryptographic proof, permitting parties to exchange the cryptocurrency with each other using the blockchain technology. It does not require a third-party clearinghouse to validate the transaction (such as a bank). A blockchain is a decentralized ledger of all transactions in a network. The blockchain technology permits participants in the network to confirm transactions without the need for a trusted third-party intermediary. A distributed ledger in a blockchain allows every participant in the network to simultaneously access and view the information on the blockchain. Cryptography permits integrity and security of the information ensuring cryptographic functions. Consensus verification is achieved by participants confirming modifications with one another, thus replacing the need to liaise with a third party to authorize transactions. Users who contribute computing power to a network are referred to as ''miners.'' Alternate coins are created through ''mining'' — a process of using computers to devise algorithm cryptographic hashes that support blocks in a blockchain.

Bitcoin, a peer-to-peer electronic cash system, was first introduced in 2008 by an unknown person or group of persons using the pseudonym Satoshi Nakamoto.[8] Frustrated with the inadequate response of central bankers to the financial market meltdown and related global recession at that time, a number of fintech innovators emerged with the introduction of bitcoin as an alternative form of money to solving the problem of inadequate trust at the central bank levels.

To better understand the taxation of cryptocurrencies, a brief review of terminology is warranted. The terms ''cryptocurrency,'' ''virtual currency,'' and ''digital currency'' are used interchangeably. A ''digital currency'' refers to an internet-based medium of exchange with characteristics similar to physical currencies. ''Virtual currency'' is a subcategory of digital currency, and is defined by the European Banking Authority as ''a digital representation of value that is neither used by a central bank or public authority nor necessarily attached to a fiat currency, but is accepted by natural or legal persons as a means of payment and

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[4] *See IRS Announces the Identification and Selectin of Five Large Business and International Compliance Campaigns* (July 2, 2018), available at https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns.

[5] *See* IR-2019-132.

[6] *See* e.g., IRS Letter 6173 (July 16, 2019), available at https://www.irs.gov/pub/notices/letter_6173.pdf.

[7] *Id.*

[8] *See* Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, The Bitcoin Project (Nov. 1, 2008).

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can be transferred, stored or traded electronically.'' The term ''cryptocurrency'' is a subcategory of virtual currency in which encryption techniques are used to regulate the various generations of units of currency and verify the transfer of funds. A ''wallet'' refers to a platform where purchased cryptocurrencies from a digital currency exchange (a platform that permits users to trade their virtual currencies for conventional currencies with other users) are stored in a digital wallet, which in turn stores a public/private key (i.e., a digital address) that allows the owner to access, use, or transfer the bitcoin. A virtual currency wallet is similar to a bank account, except it lives in a numerical address. The most common virtual currency is bitcoin. However, there are numerous others, referred to as ''altcoins,'' including ethereum, ripple, litecoin, dash, etc.[9] A ''bitcoin future'' refers to a contract that a willing buyer enters into to purchase a bitcoin at a predetermined price on a future date. A ''hard fork'' occurs where there is a change in the underlying protocol splitting the cryptocurrency in two (e.g., where bitcoin splits into bitcoin Ccash). A hard fork results in two blockchain coins. A ''cryptocurrency airdrop'' is when a blockchain distributes tokens or coins to the crypto community as a matter of protocol (i.e., without consideration). In general, to receive these coins, the taxpayer must already own cryptocurrencies from the relevant blockchain (i.e., bitcoins or ethereums). Lastly, an ''initial coin offering'' (ICO) refers to developers, businesses, and individuals using ICOs or token sales, to raise capital. Purchasers may use fiat currency (e.g., U.S. dollars) or virtual currencies to purchase virtual coins or tokens.

A bitcoin exchange allows users to purchase and sell virtual or cryptocurrencies with other virtual currencies or fiat currency. A cryptocurrency exchange is an online exchange platform that facilitates trading between cryptocurrencies, fiat currency, and other virtual currencies (e.g., bitcoins in exchange for U.S. dollars or ethereum in exchange for bitcoins). The exchange connects buyers and sellers respective to their ''bid'' and ''ask'' price. The users deposit fiat money with the exchange by sending funds (including money order, wire transfer, PayPal payment, or credit card) to the exchange prior to the execution of their trade. The exchange charges a transaction fee for x% of the value of the transaction.

Bitcoin's attraction as a virtual currency derives from its self-verifying feature where users may transfer funds instantly to another person with a bitcoin wallet as though they were paying with cash. Some merchants accept bitcoins to purchase goods (e.g., overstock.com). Even the Miami Dolphins are offering home game attendees the ability to pay with cryptocurrencies when purchasing tickets for the team's raffle endeavors.[10]

III. TAXATION OF CRYPTOCURRENCIES — A WIDE TAX NET

A. Limited Guidance from the IRS

In March 2014, the IRS published Notice 2014-21 (the ''Notice'') — the only guidance the IRS has published before issuing the IRS Letters on taxation of cryptocurrencies. As a threshold matter, the IRS analyzed whether a cryptocurrency should be classified as a currency or property for U.S. income tax purposes. In general, ''virtual currency'' is defined as ''digital representations of value that functions as a medium of exchange, a unit of account, and/or a store of value.''[11] A convertible virtual currency is defined as a subcategory of a virtual currency or one ''that has an equivalent value in real currency, or that acts as a substitute for real currency.''[12] The Notice presumably, therefore, does not address taxation of other forms of cryptocurrencies, such as those with smart contract features (ergo, ethereum). A ''smart contract'' refers to a computer protocol that automatically executes the terms of a bilateral or multiparty agreement(s) without an intermediary.

The following is a survey of topics relevant to taxation of cryptocurrencies.

1. Taxation of Virtual Currencies

At a minimum, the IRS has made it clear that for federal income tax purposes, virtual currency is treated as property.[13] General tax principles applicable to property transactions apply to transactions using virtual currency. Therefore, the rules applicable to currency transactions under subchapter J of the Internal Revenue Code[14] are not applicable and thus virtual currencies cannot generate gain or loss for U.S. federal income tax purposes.

A taxpayer who receives virtual currency as a payment for goods or services must include in its gross

[9] *See* http:/coinmarketcap.com (Aug. 8, 2018).

[10] Forbes, *Ballers and Bitcoin: Miami Dolphins Set to Accept Cryptocurrencies for Payments* (Jul. 11, 2019), available at https://www.forbes.com/sites/samantharadocchia/2019/07/11/ballers-and-bitcoin-miami-dolphins-set-to-accept-cryptocurrencies-for-payments/#3501cf397e5f.

[11] Notice 2014-21, §2 Background

[12] *Id.*

[13] *See* Notice 2014-21.

[14] Unless the context indicates otherwise, all section references are to the U.S. Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder.

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income the fair market value of the virtual currency measured in U.S. dollars as of the date that virtual currency was received. The basis of virtual currency a taxpayer receives as payment for goods or services is the fair market value of the virtual currency in U.S. dollars as of the date of the receipt. Transactions using virtual currency must be reported in U.S. dollars as of the date of payment or receipt.

Where a taxpayer receives virtual currency in excess of his or her adjusted basis, the taxpayer recognizes taxable gain. Similarly, the taxpayer recognizes loss if the market value of the property received is less than the adjusted basis of the virtual currency. In general, §1012 provides that a taxpayer's basis in property is its cost. Section 1016 provides the rules with respect to adjustment to costs (i.e., stock splits, stock dividends, corporate reorganizations, etc.). In the context of virtual currencies, in determining basis or cost at the time of sale, careful review of the basis allocations is warranted.

The character of the gain or loss will depend on whether the virtual currency is a capital asset (e.g., stocks, bonds, and other investment property) in the hands of the taxpayer. Alternatively, a virtual currency that is not treated as a capital asset will yield either ordinary gain or loss to the taxpayer on its sale or exchange. Inventory and other property held for sale to customers or in a business are treated as property that is not a capital asset.[15]

2. Taxation of Activities of Miners

A taxpayer who ''mines'' virtual currency realizes gross income upon receipt of the virtual currency at fair market value and as of the date of receipt. Furthermore, if a taxpayer's ''mining'' of virtual currency constitutes a trade or business, and the mining activity is not undertaken by the taxpayer as an employee, the Notice requires the net earnings from self-employment (gross income less allowable deductions) resulting from those activities to yield self-employment income subject to self-employment taxes.

Similarly, where an independent contractor performs services constituting self-employment income and receives virtual currency for performing services, the fair market value of virtual currency received from services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income, subject to self-employment taxes. The Notice is silent as to whether ordinary and necessary business expenses under §162 associated with mining should be deductible.[16]

3. Application of the Wash Sales Rule Under §1091

The application of the wash sales rules under §1091 to cryptocurrencies is uncertain. Very generally, a wash sale is a transaction where an investor sells stock or securities at a loss and then repurchases the *same identical stock or securities* back within a 30-day window. Congress, to ensure that a taxpayer isn't able to claim a loss on essentially a phantom loss that has been created without any change in economic substance, enacted §1091 to disallow the loss. In addition, for §1091 to apply, the loss must be that of ''stock or securities'' and related contracts or options to acquire or sell ''stock or securities.''[17] In the context of cryptocurrencies, it is difficult to assess the application of the wash sales rules as the classification of a cryptocurrency or virtual currencies for purposes of these rules remain open and subject to debate.

4. Application of the Straddle Rules Under §1092

Very generally, the straddle rules under §1092 address offsetting positions in personal property that is actively traded. The Code defines offsetting positions to mean ''positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property.''[18] Section §1092straddle rules may be applicable to cryptocurrencies provided: (i) a virtual currency is treated as personal property for which there is an established market; and (ii) there are offsetting positions that may result in substantial diminution of risk of loss for that property. In the context of virtual currencies, the straddle rules may provide planning opportunities by deferring the recognition of losses and modifying the holding period of disposed property as per the rules.[19]

5. Accounting Method Rules Relating to Virtual Currencies

To date, the IRS has not provided any guidance with respect to the appropriate accounting method for the sale of cryptocurrencies. A taxpayer may choose from three acceptable methods of computing gains and losses, namely: First-In First-Out (FIFO), Last-In Last-Out (LILO), and Specific Identification. In the

[15] *See* Notice 2014-21 and IR-2014-36.

[16] *See* Notice 2014-21. *See also* AICPA Comments on Notice 2014-21 (June 10, 2016); IR-2014-36.

[17] *Id.*

[18] *See* §1092(c)(2)(A).

[19] *See also* §1092(a)(1); Reg. §1.1092(b)-1T, Reg. §1.1092(b)-2T.

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absence of regulatory guidance, a taxpayer should ensure substantiation of documentation detailing each cryptocurrency transaction.

6. Treatment of Like-Kind Exchanges Prior to TCJA

Effective for exchanges completed after December 31, 2017, the non-recognition of gain or loss on ''like-kind exchanges'' is only permitted on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property. Prior to the enactment of the Tax Cuts and Jobs Act (TCJA),[20] §1031 treatment was available to the exchange of one virtual currency for another virtual currency. For example, a taxpayer may have exchanged bitcoin for ethereum and vice-versa.

Section 1031 is a non-recognition provision that provides an exception to the rule that all realized gains must be recognized. The underlying principle for a ''like-kind'' exchange is that the exchange of one asset for another does not trigger any economic gain. The assets are essentially swapped. Given that virtual currencies or cryptocurrencies have been classified as ''property'' under the Notice, the provisions of §1031 may be applicable to pre-TCJA virtual currency exchanges. The only limitation to the provision as provided in the regulations is that the definition of ''like-kind'' refers to ''the nature or character of the property and not its grade or quality.''[21] However, there are some nuances to the statute. For example, real property situated in the United States and real property situated outside of the United States is not deemed ''like-kind.''[22] In the context of commodities, the exchange of silver bullion with gold bullion does not meet the requirements of §1031; however gold bullion may be exchanged with gold bullion.[23] The IRS has not provided guidance as to the treatment of cryptocurrencies in the context of ''like-kind'' exchanges prior to the enactment of the TCJA. However, taxpayers who maintain a ''like-kind'' exchange position in the context of cryptocurrencies should ensure that they are fulfilling the reporting and disclosure requirements, including filing Form 8824, *Like-Kind Exchanges.*

7. Tracking Capital Gains and Losses With Cryptocurrencies

The IRS has also not addressed how to track the computation of capital gains and losses (basis and fair market value) in the context of ''convertible'' virtual currencies. A ''convertible'' virtual currency (e.g., a bitcoin) is one that can be freely exchanged into another virtual currency without regulatory oversight. When a virtual currency is used to purchase goods or services, a transaction occurs where parties are required to track the fair market value (FMV) of the currency at the time of the transaction. The taxpayer's cost or basis will determine whether a gain or loss has occurred as well as its duration (short-term or long-term transaction).

Some practitioners have suggested simplifying the burdensome record-keeping requirements that are necessary to calculate virtual currency gains and losses by applying §1012 tracking methods under FIFO, LIFO, or the specific identification method akin to the way stocks are sold through an exchange.[24] In addition to the above, some practitioners have suggested the IRS should provide a *de minimis* rule for taxpayers who may have a minimal amounts of virtual currency transactions or small transactions (e.g., purchasing coffee).[25]

8. Valuation Methods Used to Value Cryptocurrencies

According to Notice 2014-21, transactions using virtual currency must be reported in U.S. dollars. In addition, taxpayers will be required to determine the FMV of the virtual currency in U.S. dollars as of the date of receipt. The IRS has provided that ''if a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) and the exchange rate, in a reasonable manner that is consistently applied.''[26]

The IRS fails to consider, however, how taxpayers should value, for example, tokens issued by companies that are not listed on an exchange with an established exchange rate. In addition, the IRS does not address the fact that there are numerous published exchanges and the values reported on those exchanges fluctuate. For example, Coindesk, Blockchain, Xapo, Google, Gemini, Winkdex, Bitstamp, and Kraken, all report bitcoin with slight variations. Some members of Congress have written to the IRS's Commissioner

[20] Pub. L. No. 115-97 (Dec. 2017).
[21] *See* Reg. §1.1031(a)-1(b).
[22] §1031(h)(1).
[23] *See* Rev. Rul. 82-166.
[24] *See* Reg. §1.1012-1(c).
[25] See AICPA Letter to the IRS (May 30, 2018), available at https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180530-aicpa-comment-letter-on-notice-2014-21-virtual-currency.pdf.
[26] Notice 2014-21, Q-5, A-5.

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in hopes for additional guidance on this narrow query.[27]

9. Application of Cryptocurrencies and Tokens in the Context of Charitable Giving, Gifts, Trusts and Estates

Notice 2014-21 has confirmed that virtual currency should be treated as property for federal income tax purposes. However, because of the volatility and valuation issues pertaining to ascertaining the FMV of a cryptocurrency, most estate planners and fiduciaries exercising the ''prudent investor rule'' have been hesitant to structure cryptocurrency assets (transfer in trusts or as gifts). Queries surrounding valuation, determining how to claim lost tokens, and how to report cryptocurrencies on an estate tax return, among others, remain open issues. In addition, the IRS has not provided more robust guidance in terms of the transfer of virtual currencies in the context of charitable donations. According to the Fidelity Charitable 2018 Report, donations made to Fidelity Charitable using bitcoin grew to $69 million in 2017, nearly tenfold from the previous year.[28] However, absent IRS guidance, investors who have made charitable contributions to a §501(c)(3) organization may face capital gains taxes for the cryptocurrencies they cashed. The investor may also ''gift'' the cryptocurrency directly to the charity without cashing the asset first and deduct the value of the donation, provided the assets were held for longer than one year.

Very generally, subject to a limited exception involving ''readily valued property'' such as publicly traded stock, a charitable contribution of property with a value of more than $5,000 requires a qualified appraisal from a qualified appraiser as well as an acknowledgement letter from the charity and a completed Form 8283, *Noncash Charitable Contributions.* In the context of cryptocurrencies, such as bitcoins, the IRS requires a taxpayer to provide valuation as provided in established markets. However, because cryptocurrencies are nascent, there are no established markets to offer accurate valuation which vastly fluctuates in terms of price on any given day. Practitioners have suggested a rule that would allow taxpayers to rely on an average of two established virtual currency markets and the substantiation requirements of §170(f),[29] however the IRS has not provided any specific guidance to date on this score. In the absence of reliable guidance from the IRS, however, taxpayers should follow the rules for donated property.

10. Taxation of Initial Coin Offerings (ICOs)

In general, a company may wish to issue a token to either: (i) raise capital; or (ii) use the company's platform to purchase goods and services. For marketing purposes, a company may also wish to air drop tokens (give away tokens for free) to raise awareness of its platform. Other tokens may have equity-like features, such as the right to dividend-like payments based on the issuer's predefined performance objectives. Some tokens' underlying utility may be blurred between debt and equity and the purpose of the investor (redeem to use on the company's platform or hold for appreciation in value).

While Notice 2014-21 provides guidance with respect to the IRS's views that convertible virtual currency is treated as property — and not as currency — for tax purposes, the IRS has not provided any guidance with respect to the tax treatment of a cryptocurrency issuer.

The tax treatment of ICOs is also unclear. Token issuances, also referred to as ICOs, took an unprecedented rise recently across the globe. An ICO permits a company to raise capital without issuing traditional debt or equity and to use the tokens to purchase goods and services. Each token has its own specific feature and functionality (i.e., authorized as a payment system for purchase of goods and services). In addition, some tokens have equity-like features permitting its holder to dividend payments based on the issuer's preference or objectives.

The federal income tax treatment of tokens depends on the issuer's location, onshore or offshore, as well as how the token is initially structured. The IRS has stated that it views a convertible virtual currency as property (and not as currency) for tax purposes. However, it has yet to provide guidance on the tax treatment of a crypto issuer. The first query is to analyze whether a crypto token is treated as debt or equity for federal income tax purposes.[30] The second query is to determine whether the issuing company is a domestic or foreign corporation. If the issuing company is a foreign corporation, careful analysis with respect to the federal income tax rules pertaining to taxation of a controlled foreign corporation (CFC), Passive Foreign Investment Company (PFIC), and the international tax nuances enacted in the TCJA is warranted.

For example, an offshore foreign corporation with U.S. owners that meets the requirements of the CFC rules may be faced with subpart F and global intangible low-taxed income (GILTI) includible in the U.S. taxable income of any direct or indirect U.S. shareholder. Under the TCJA, U.S. shareholders of a CFC

[27] *See* Congressional letter to the Commissioner of the IRS (Apr. 11, 2019), available at http://src.bna.com/HhY

[28] *See* Fidelity Report, available at https://www.fidelitycharitable.org/content/dam/fc-public/docs/insights/2018-giving-report.pdf.

[29] AICPA Comments on Notice 2014-21 (June 10, 2016).

[30] *See Dixie Dairies Corp. v. Commissioner,* 74 T.C. 476 (1980) (listing 13 factors).

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must include U.S. taxable income in their annual pro rata share of GILTI.[31] In the context of issuance of tokens by a foreign corporation that meets the requirements of a CFC, a practitioner should estimate the amount of GILTI a CFC will likely produce in a token sale and parse through the requirements of §951A(a), et al.

A hard fork occurs where there is a change in the underlying protocol splitting the cryptocurrency in two (e.g., where bitcoin splits into bitcoin cash), thus resulting in two blockchain coins. As a result of a hard fork, the taxpayer obtains a new coin (e.g., bitcoin cash) in addition to the original coin. The government has not addressed the tax treatment of a hard fork in the cryptocurrency context. However, some tax practitioners have analogized the treatment to that of a stock split or stock dividend. On March 19, 2018, the American Bar Association's Section of Taxation requested the IRS to issue temporary guidance on "hard forks" including providing a safe harbor for taxpayers whose cryptocurrency split into different currencies.[32]

11. Loss of Private Key or Password

One of the key attributes of virtual cryptocurrency is anonymity, except for the owner whose virtual currencies are protected by a private digital key that is unique and secured by a password only known by the owner. If the owner (an individual) misplaces the private key or loses his password, the virtual currency is inaccessible and forever lost. The Code allows noncorporate taxpayers a deduction for certain losses arising from fire, storm, shipwreck, or other casualty, or from theft, incurred with respect to property that is neither used in a trade or business nor held in a transaction entered into for profit.[33]

For tax years beginning in 2018 through 2025, an individual's otherwise deductible personal casualty and theft losses generally are deductible only to the extent that they are attributable to a federally declared disaster. Prior to the enactment of the TCJA, casualty losses under §165 were allowable. While the IRS and the Notice have not provided any guidance on this issue as it relates to virtual currencies, it is unlikely that the IRS would permit a casualty loss deduction prior to the TCJA with respect to virtual currencies for merely misplacing a private key.

12. Tax Implications in Case of Theft

In 2014, a virtual currency exchange platform referred to as "Mt. Gox" lost millions of dollars' worth cryptocurrencies for its investors.[34] A few years later, nearly 120,000 bitcoins were stolen from customer accounts at Bitfinex, an exchange platform in Hong Kong.[35] The IRS has not provided guidance as to whether taxpayers could deduct virtual currencies that would meet the requirements of §165 prior to the TCJA or for years before 2018. As with the theft of other financial assets, if the virtual currency was acquired in a transaction entered into for profit, a theft loss would be deductible.

In addition to the ambiguities stated in the examples above, it would be helpful if the IRS provided guidance as to the tax consequences of cryptocurrencies in the context of funds and, more specifically, trading, investing, and mining of cryptocurrencies. For example, is the raising of funds recognized as income? What is the difference between stock offerings versus sale of goods and services? Does the 3.8% net investment income tax apply to virtual currencies? What is the treatment of restricted tokens provided to employees as additional compensation under §83? Should they be treated akin to the treatment of receipt of restricted stock? The IRS has not provided any guidance on these queries other than the general principles stated in the Notice.

B. Litigation — A Growing Enforcement Initiative

At the American Institute of CPAs National Tax Conference in Washington, D.C., late last year, the recently appointed Commissioner of the IRS, Charles Rettig, opened his comments with: "*Remember Coinbase*?"[36] On November 17, 2016, the DOJ, acting on behalf of the IRS, requested permission from the U.S. District Court for the Northern District of California to serve a John Doe Summons (the "Coinbase Summons") on Coinbase, Inc.[37] Coinbase, a company based in San Francisco, is an exchange platform that facilitates the trading of cryptocurrencies. Customers may purchase, trade, and store cryptocurrencies (e.g., bitcoin or ethereum) on its platform. From 2013

[31] *See* §951A(a).

[32] ABA Section on Taxation, Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017 (Mar. 19, 2018), available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/031918comments2.authcheckdam.pdf.

[33] *See* §165(c)(3).

[34] *See, e.g., Mountain of Trouble Twice-Burned — How Mt. Gox's Bitcoin Customers Could Lose Again,* Reuters (Nov. 16, 2017).

[35] *See, e.g., Bitcoin Worth $72 Million Was Stolen in Bitfinex Exchange Hack in Hong Kong,* Reuters (Aug. 2, 2016).

[36] ABA Section on Taxation, Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017 (Mar. 19, 2018), available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/031918comments2.authcheckdam.pdf.

[37] *See United States v. Coinbase, Inc.,* No. 17-cv-01431, 2017 BL 248202, 2017 WL 3035164, at *1–2 (N.D. Cal. July 18, 2017).

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through 2015, Coinbase maintained over 4.9 million wallets in 190 countries with 3.2 million customers served and $2.5 billion exchanged.[38]

The Coinbase Summons initially targeted to obtain ''information regarding United States persons who, at any time during the period January 1, 2013, through December 31, 2015, conducted transactions in a convertible virtual currency as defined in IRS Notice 2014-21.''[39] As a result of the large number of potential customers that would fall within this broad spectrum, the request was later modified to Coinbase users who ''bought, sold, sent or received at least $20,000'' worth of cryptocurrency in a year.[40] A year later, on November 28, 2017, the U.S. District Court granted DOJ's petition. The Coinbase Summons was a wake-up call for taxpayers who had quietly amassed a fortune in virtual currencies and who had failed to report to the IRS their gains that the government intended to collect its share of tax. The Commissioner was in fact warning the audience that the IRS was bolstering its enforcement capabilities to find and prosecute taxpayers who fail to report their cryptocurrency gains.

IV. REPORTING

A. Tax Reporting and Filing Requirements

In general, §6001 provides record keeping requirements for income tax purpose. The Code requires for each person to keep adequate records. Consequently, proper record keeping is required to substantiate a position on a return for income, loss, and basis amounts. In the context of virtual currencies, a payment made using virtual currency is subject to information reporting. Critical to accurate reporting is maintenance of adequate records to measure virtual-currency related income.

Consider the following example. A person who in the course of a trade or business makes a payment that is treated as fixed and determinable income (i.e., FDAP-like types of income, including rent, salaries, wages, premiums, annuities, and compensation) using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Payments of virtual currency are required to be reported on Form 1099-MISC, *Miscellaneous Income,* using the fair market value of the virtual currency in U.S. dollars as of the date of payment.[41]

All federal insurance contributions including Federal Insurance Contributions Act (FICA) tax must be reported on Form W-2, *Wage and Tax Statement.* Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. A payor must solicit a Taxpayer Identification Number (TIN) from a payee. In the absence of a TIN, a payor must backup withhold from a payee prior to payment if the payor receives notification from the IRS that backup is required. Thus, employer payments with virtual currencies as a form of payment for services constitute wages for employment tax purposes and are subject to federal tax withholding.[42]

Very generally, credit card intermediaries are subject to specific information reporting if in a calendar year more than 200 transactions are settled for the merchant and gross proceeds payments made to the merchant exceed $20,000. These third-party settlement organizations (TPSO) are required to report payments made to a merchant on Form 1099-K, *Payment Card and third-party Network Transactions,* if the above conditions are met. Notice 2014-21 provides that payments made in connection with bitcoin transactions or other virtual currency may be reportable on Form 1099-K. For reporting purposes, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.[43]

The Notice, however, fails to consider information reporting requirements of virtual currency transactions in exchange for property or cash that are not reportable on Form 1099-K. Instead, it provides a catch-all provision where taxpayers will be subject to penalties for failure to comply with tax laws, including virtual currency transactions. It also provides that underpayments attributable to virtual currency transactions may be subject to penalties, including accuracy-related penalties under §6662. Failure to correctly report virtual currency transactions may also subject the taxpayer to information reporting penalties under §6721 and §6722. The Notice does, however, provide relief under reasonable cause for failure to file an information return.

To avoid the above penalties, taxpayers engaging in virtual currency transactions should ensure they have a record keeping system to track the basis and gains or losses of each transaction. In particular, it would be prudent to keep track of all acquisition and sell dates, and any other cost basis information. It is unclear, at

[38] *Id.*

[39] *Id.* at 4.

[40] *Id.*

[41] *See* Notice 2014-21; *see also* IR-2014-36.

[42] *See* Notice 2014-21; *see also* IR-2014-36.

[43] *See also* IR-2014-36.

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this time, whether taxpayers will be required to record all transactions on Schedule D, Form 8949, *Sales and Other Dispositions of Capital Assets.* For example, issuers of virtual currency may wish to create a tracking system or inventory for each currency issued. Similarly, retailers accepting virtual currencies should retain documentation on the amount of their sales. Documentation should be stored to provide substantiation or verify the value of the virtual currency at the time of the transaction in U.S. dollars.

It is also unclear at this time whether U.S. persons are required to reports gifts of virtual currency from a non-U.S. person or distributions from a non-U.S. entity (e.g., a foreign trust) on Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*

Taxpayers are, generally, required to report cash payments exceeding $10,000 received in a trade or business on Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business.* Cash payments are defined to include U.S. currency, foreign currency, cashier's checks, money orders, and other similar instruments.[44] Given that Notice 2014-21 provides that virtual currencies are not currency, presumably Form 8300 reporting does not apply to virtual currencies.

B. International Considerations: Information Reporting Abroad

Notice 2014-21 also does not provide any guidance as to whether owners of virtual currencies must fulfill international reporting requirements. In general, United States citizens, lawful permanent residents, or individuals with substantial presence in the United States (i.e., U.S. persons) must file a Foreign Bank Account Report (FBAR) with the Treasury Department's Financial Crimes Enforcement Network (FinCen) where the U.S. person has a financial interest in, or authority over, any financial account outside of the United States where the aggregate maximum value of the account(s) exceeds $10,000 at any time during the calendar year. A ''financial account'' for FBAR reporting requirements, includes the following:

- Bank accounts (e.g., savings accounts), checking accounts, time deposits or any other account maintained at a financial institution;
- Securities accounts such as brokerage or custodial accounts;
- Commodity futures or options accounts;
- Insurance policies or annuity contracts;
- Mutual funds or pooled funds; and
- Some pension funds and retirement accounts (excluding those under §401(a), §403(a), or §403(b)).

A ''U.S. person'' has a ''financial interest'' where: (i) the U.S. person is the beneficial owner of the account or has legal title to the account; or (ii) the holder of the account is a person acting as an agent, nominee, attorney, or otherwise a person acting on behalf of the U.S. person with respect to the account.

The IRS has not provided guidance at this time as to whether a taxpayer holding cryptocurrencies on a foreign cryptocurrency exchange (e.g., Xapo.com or Binance.com) or in a foreign virtual wallet (e.g., Blockchain.com) is required to report the account(s) on an FBAR within the meaning of the above types of accounts. However, based on the language contained in the IRS Letters, it appears evident that taxpayers holding cryptocurrencies in a foreign exchange or wallet will be subject to the same type of FBAR reporting. Under the heading ''Reporting Virtual Currency Transactions,'' IRS Letter 6174 provides that the obligation to report all sales, exchanges, and other dispositions of virtual currency ''applies regardless of whether the account is held in the U.S. or abroad.''[45] Taxpayers who have cryptocurrencies outside of the United States should therefore revisit their positions to ensure that they are compliant with all international tax reporting obligations, including FBARs.

In addition to the above, U.S. persons must also provide a Form 8938, *Statement of Specified Foreign Financial Assets,* annually with their income tax return regarding a ''specified foreign financial asset.''[46] The financial assets that must be reported on the Form 8938 is broader than what is required to be reported on an FBAR, and includes among other categories, ''any financial account . . . maintained by a foreign financial institution'' and ''any interest in a foreign entity.''[47]

For example, a taxpayer holding cryptocurrencies in *physical form* (i.e., not in cash), on a foreign virtual currency exchange (e.g., Xapo.com) or a wallet (e.g., Blockchain.com) would presumably be required to report the accounts for purposes of Form 8938 given that the taxpayer is holding a financial account (the wallet) maintained by a foreign financial institution (the exchange). Additionally, a Form 8938 reporting requirement may apply to the extent a U.S. person owns ''an interest [the cryptocurrency] in a foreign

[44] *See* §6050I(a); Reg. §1.6050I-1.

[45] *See* IRS Letter 6174 (6-2019), July 16, 2019, available at https://www.irs.gov/pub/notices/letter_6174.pdf.

[46] *See* §6038D; Reg. §1.6038D-0– Reg. §1.6038D-8.

[47] *See* Instructions to Form 8938, Part I and V.

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entity [a cryptocurrency exchange or wallet that is formed under the laws of a foreign country].'' Again, leaning on the language in the IRS Letters, a taxpayer holding a cryptocurrency on a foreign virtual currency is well-served to report his or her interest on Form 8938.

Contrast those examples with, for example, virtual currency exchanges formed in the United States (e.g., Coinbase.com or Gemini.com) where those assets would not be classified as ''specified foreign financial assets'' and thus normally not subject to Form 8938 reporting.

At this time, the government has not provided guidance as to whether taxpayers who own (i) an account on a foreign digital exchange, (ii) a foreign digital wallet, or (iii) a foreign private key should report any of these interests on an FBAR and Form 8938. However, based on the language in the IRS Letters, it would appear that the government intends to enforce reporting for taxpayers who hold cryptocurrencies abroad.

V. TAKEAWAY

Cryptocurrencies are here to stay. The IRS's ''wake-up'' call to enforce administration of taxation of cryptocurrencies has just begun. Much like taxpayers with accounts overseas for nefarious activities who didn't believe FATCA had any teeth; so too will non-compliant taxpayers with cryptocurrency accounts and transactions that have not been reported to the IRS find themselves in a precarious position when the government contacts them for an explanation. However, in all fairness, given the growth and breadth of virtual currencies, the government also needs to provide additional guidance supplementing the one Notice it has issued.[48] In the meantime, tax practitioners should become well-versed with the use and rise of cryptocurrencies (and the underlying technology, blockchain) to better advise taxpayers who will need their services in the future.

[48] *See* Letter from Commissioner Charles Rettig to Honorable Tom Emmer and U.S. House of Representatives (May 16, 2019), available at: https://emmer.house.gov/sites/emmer.house.gov/files/5.16.2019%20emmer%202019-11771.pdf.

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