IRS Scrutiny of Bitcoin & Cryptocurrency
Taxable Income: Today’s Calculation
Challenges

American Bar Association Section of Taxation 2019 Fall Meeting
San Francisco, CA, October 2019

Panelists: **Stevie D. Conlon**, Vice President, Wolters Kluwer, Chicago/Boston
**Rebecca E. Lee**, Principal, PwC, Washington DC
**Nicholas Mowbray**, Associate, BakerHostetler, Washington DC
Overview

- Taxation of Cryptocurrencies
- Potential Alternative Cryptocurrency Taxation
- Reporting Concerns - Cryptocurrencies
- Challenges Specific to Cryptocurrencies
Taxation of Cryptocurrencies
Introduction

- The IRS has issued one substantive piece of tax guidance regarding the treatment of cryptocurrencies – Notice 2014-21.

- Complexity in this space has increased exponentially in the last five years:
  - There is substantial diversity in the types of cryptocurrency issued.
  - The sheer number of coins/tokens/etc. have increased.
  - The “use cases” for cryptocurrency have expanded.
  - Market acceptance for the asset class has expanded to institutional and mainstream investors.
  - Availability of exchange-traded futures contracts provided an additional investment option.
  - Non-tax regulators have been active in the space – and not merely with enforcement actions.
  - Mainstream acceptance of certain virtual currencies as medium for payment for goods and services has expanded.
IRS issued a press release on July 26, 2019 announcing that they had begun sending letters to taxpayers with virtual currency transactions that potentially failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions properly.

- By the end of August, more than 10,000 taxpayers will receive these letters. The names of these taxpayers were obtained through various ongoing IRS compliance efforts.

- Per IRS Commissioner Chuck Rettig: "The IRS is expanding our efforts involving virtual currency, including increased use of data analytics. We are focused on enforcing the law and helping taxpayers fully understand and meet their obligations."

- The IRS describes the letters as “educational letters.”
IRS Letters (July - August 2019)

- For taxpayers receiving an educational letter, there are three variations:
  - Letter 6173,
  - Letter 6174 or
  - Letter 6174-A
- All three versions strive to help taxpayers understand their tax and filing obligations and how to correct past errors.
- Note that the 6173 letter requires a taxpayer signature under penalties of perjury confirming that the amount reported on the tax return is correct.
IRS Notice 2014-21 (Refresher)

- First and only formal guidance on cryptocurrency
  - Relates to “convertible” virtual currencies that have equivalent value in a real currency
  - At time of issuance, almost all tokens in circulation were intrinsic tokens such as Bitcoin or Ethereum
- Treats cryptocurrency as property, with general tax principles that are applicable to property transactions applying
  - I.R.C. § 1001 applies, so every disposition is a disposition of property
    - Record and track basis
- Wage income and employment taxes
- Valuations
  - Listed exchanges
- Disallows inferences to be drawn with respect to cryptocurrencies not described in notice
Potential Alternative Cryptocurrency Taxation
Sec. 988, Token Taxonomy Act

- The nonfunctional currency rules of Sec. 988(e)(2) include a *de minimis* exclusion of $200
  - But Notice 2014-21 states cryptocurrency is property, not a currency

- Token Taxonomy Act (H.R. 7356)
  - Introduced in 2018 by Rep. Warren Davidson, R-Ohio
  - Reintroduced in 2019 as HR 11, proposes Sec. 139G carveout for small dollar personal transactions
  - Would, *inter alia*, treat qualified exchanges of virtual currency as tax-free exchanges and exclude gain up to $600
Sec. 1031 Like Kind Exchanges, Before and After Tax Cuts and Jobs Act

- TCJA’s modification of I.R.C. § 1031
  - I.R.C. § 1031 Only applies to real estate
    - Exclusion of intangible property from eligibility under Sec. 1031 is effective for transactions occurring on or after Jan. 1, 2018
- Pre-2018 exchanges
  - One cryptocurrency of a “like kind” to another?
- Token Taxonomy Act (H.R. 7356) was introduced in 2018
  - Generally allows cryptocurrency holders to make tax exempt like-kind exchanges under I.R.C. § 1031 and excludes cryptocurrency and other “digital tokens” from the definition of a security
- Safe Harbor for Taxpayers with Forked Assets Act (H.R. 3650) was introduced in July 2019 by Tom Emmer, R-Minnesota
  - Prevents penalty assessments on taxpayers that improperly reported their gains or losses from “forked” assets until the agency issues long-awaited guidance on their proper tax treatment
Different Types of Coins – What’s in a name?

- Types of coins/tokens:
  - Base case: Coins/Tokens without an individual sponsor/issuer
    - E.g., Bitcoin, Ethereum, etc.
  - Utility tokens
  - “Security” token
    - Impact of the SEC Howey Test
    - See the recent Overstock.com “digital” stock distribution
  - Stable value coins
  - Initial Coin Offerings – is this a separate category?
Different Types of Coins – What’s in a name?

- Factors potentially affecting characterization:
  - Non-tax regulatory treatment
  - Rights/obligations of the holder
  - Issuer categorization

- Could a coin/token have different categorizations for different tax purposes
  - Compare the definition “commodity” under section 475 versus 864(b) versus section 954 (subpart F rules)?
  - Impact of the new cloud computing regulations?

- Does the usage of the coin/token matter for characterization?
  - Airdrops
  - Proof of Stake
  - Compensation
  - ICO-financed distributions
Reporting Concerns - Cryptocurrencies
Basis Tracking

- If a taxpayer has acquired blocks of the same cryptocurrency at different times and disposes of some, but not all of such cryptocurrency, how are basis and holding period determined?
  - May the fund track separate lots acquired on different dates? If so, specific identification? FIFO? *Cf.* Treas. Reg. § 1.1012-1(c).
  - Basis pooling, comparable to the basis of certain partnership interests or to the average-basis method that can be elected with respect to shares of RICs?
  - If basis is pooled, would each portion of the aggregate amount of cryptocurrency have a split holding period, as is the case for a partnership interest, or would the holding period be determined otherwise (*e.g.*, on a FIFO basis, as in the case of a RIC shareholder that elects the average-basis method)?
Lot Identification – Practical Challenges

- How are transactions on a single day treated? Must separate intra-day purchases be treated as separate lots?
- Is information needed to determine lot-level basis available?
- What does it mean to apply “specific identification” to these assets? Are books-and-records designations sufficient? Whose books-and-records?
- Are there other rules (wash sale, straddle, etc) that might affect basis or holding period?
- For security tokens, are there constructive sale considerations? Consider pending Overstock digital distribution and stock shorting behaviors.
- How do these considerations converge with the data available (see below)?
Challenges Specific to Cryptocurrencies
Challenges – Appropriate Valuation Rules?

- Cryptocurrency is intangible property – generally difficult to value
- Restricted stock or non-publicly traded rules?
  - Courts have noted difficulty in cases such as Ames v. O’Malley, 91 F. Supp. 463 (D. Nev. 1950), aff’d 197 F.2d 256 (8th Cir. 1952)
- Special rules where no sales or bid/ask or for open-end funds
- Values immediately pre-1929 crash - W.T. Grant Co. v. William Duggan, 94 F.2d 859 (2d Cir. 1938)
- Closely held corporations? Rev. Rul. 59-60, 1959-1 CB 237
Challenges – Data and Manipulation

- Cryptocurrency markets are worldwide – Prospective traders may simply look for lowest price/barrier to entry in deciding which market to trade in, leading to many active markets
- Significant manipulative trading and wash sale concerns have been reported
  - Between 70% and 95% of trading on some exchanges
- Data on direct trading (e.g. atomic swaps, etc.) generally unavailable
- No market segregation of Bitcoin – US Bitcoin = French Bitcoin
  - Should cause price reconciliation; often has not
  - Can infer potential wash trading/manipulated exchanges
- More regulated exchanges such as Binance, Coinbase, Kraken, etc. tend to display much more similar pricing patterns
Forks and Drops – Timing and Character

- Fork: technological change to rules governing a blockchain; post-change blocks may be compatible with pre-change software (soft fork) or may not (hard fork)
- Drop: means of distributing a new cryptocurrency to all or certain holders of another cryptocurrency
- Recognition of income on found property? *Comm’r v. Glenshaw Glass*, 348 U.S. 426 (1955)
- Coins held on exchanges – when (if ever) is new coin received?
  - How would you compute basis allocations?
- Valuation considerations – ambiguously divisive forks such as Bitcoin Cash -> Bitcoin SV and Bitcoin ABC
Forks and Drops – Continued

- ABA Section of Taxation provided recommendations re: cryptocurrency forks in letter to IRS dated March 19, 2018
  - Recommended guidance prescribing that:
    - Receiving forked coin was a taxable event
    - Deemed value at time of receipt should be zero (regardless of actual value)
    - Holding period would start day of fork (normally holding period begins day following event)
  - Safe Harbor for Taxpayers with Forked Assets Act
    - Proposed safe harbor without penalty until additional guidance
Corporate Tax Analogies

- Stock split or stock dividend? Corporate spin-off?
- Increased number of shares and coins, no change in ownership percentage
- Corporate actions have governing regulatory frameworks under Subchapter C
  - None yet for forks/drops, only proposals
  - Note publicity around distribution of Overstock tokenized shares
- Is comparison to corporate action at all appropriate?
- In a blockchain like Bitcoin, is there a corporate body to act or act upon? What about organizations creating dapps in Ethereum?
- Pool of miners/owners vs. pool of assets/shareholders
Bitcoin vs. Bitcoin Cash
Conclusion

- Thank You!