Taxation of Crypto Gains and Losses

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Disclaimer: These slides were not prepared by, and do not reflect the views of, the Treasury Department or the IRS.

Review: Basics of Gains and Losses

- How we deal with property:
  - Acquire or create it
    - Basis is a focus of this panel
      - Amount paid to acquire asset (cash, other property, services provided, debt assumed)
      - Acquisition costs
  - Use it (not a focus of this panel)
  - Dispose of it – a focus of this panel
    - Sell
    - Exchange
    - Donate to charity
    - Gift it to a relative or transfer it upon death
    - Theft – property is stolen from owner
    - Abandoned by owner
    - Worthlessness
    - Termination of some type (for example, digital asset disappears; blockchain taken down, no one verifying transactions anymore, etc.)
  - Recordkeeping needed for all the above (§6001 and regs and §1001, et seq)
    - May have information reporting forms to help and that need to be reconciled to taxpayer records.

IRS Guidance and Information on Digital Assets Relevant to Gains and Losses

- Prop. Regs. under §1001, §1012, §6045 on broker reporting changes made by IIJA (P.L. 117-58, 11/15/21)
- IRS Notice 2014-21 – Treat convertible virtual currency transactions as involving property (rather than foreign currency)
- Revenue Ruling 2019-24 & CCA 202114020 – treatment of a hard fork
- Notice 2023-27 – IRS suggestion and solicitation of comments on when NFTs might be collectibles
- Revenue Ruling 2023-14 – Coins received from proof of stake are taxable when received (and that amount becomes basis of the coins)
- FAQs on virtual currency transactions (released Oct. 2019)
- CCA 202124008 – Application of §1031 to exchanges of Bitcoin, Ether, Litecoin
- CCA 202316008 – Change of consensus mechanism
- CCA 202302011 – Applicability of §165 to cryptocurrency that as declined in value
- CCA 202302012 – Qualified appraisal requirement for donations of cryptocurrency

Links to above - https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets

Key IRS Guidance - Notice 2014-21*

- Virtual Currency is a digital representation of value that functions as
  - A medium of exchange
  - A unit of account, and/or
  - A store of value
- "In certain contexts, virtual currency may serve one or more of functions of "real" currency.... But the use of virtual currency to perform "real" currency functions is limited."
- For federal tax purposes, virtual currency is treated as property. General principles applicable to property transactions apply to transactions using virtual currency.

*Background section of Notice 2014-21 modified by Notice 2023-34 due to El Salvador treating bitcoin as legal tender; but no change to substance of Notice 2014-21.

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Created Digital Assets

- How did Satoshi Nakamoto treat costs of creating Bitcoin?
  - We're not addressing this – just something for you all to ponder later!
- Virtual currency received from a hard fork?
  - Basis = amount reported as income when received
  - Any costs to acquire should be added to basis (perhaps there were costs to acquire a software tool to access the new currency)
- How should taxpayer keep track of income and basis from these activities?
  - Will any of the above activities generate an information reporting form?

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Digital Assets From a Consensus Protocol Award

- Basis = amount reported as income when received
  - Notice 2014-21 (mining) and Rev. Rul. 2023-14 (staking)
- Costs of mining or staking?
  - If the income from the activity is reported as services income, arguably, the expenses to produce that income are §162 (or §212) deductions.
    - N2014-21, Q-8: VC rec'd from mining is gross income at FMV upon receipt.
  - If there is no gross income until disposition, how are costs treated?
- How should taxpayer keep track of income and basis from these activities?
  - Will any of the above activities generate an information reporting form?

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Acquired Digital Assets Using Cash, Cryptocurrency, Goods, or Services

- Cryptocurrency acquired using (assuming these are arm's length transactions):
  - Cash: Basis = purchase price including any transaction fee
  - Services or goods (such as a merchant might do or an employee might receive as compensation): [N2014-21, Q-3, Q-4]
    - FMV of the virtual currency when received [FAQ 21]
    - FMV of goods or services received if cryptocurrency not treaded on an exchange or have a published value [FAQ 28 and *Philadelphia Park Amusement*, 126 F.Supp. 184 (1954)]
    - Note: For retailers measuring for sales tax purposes, they may be required to use the sales price of the goods or services rather than list price of the cryptocurrency (for example: Kansas Notice 20-04) or the FMV of the cryptocurrency used (for example, Michigan, New Jersey, and New York).
  - Another cryptocurrency using a cryptocurrency exchange: Use USD amount that the exchange used. [FAQ 26]
  - Another cryptocurrency using in a peer-to-peer transaction: Use value at time exchange recorded on distributed ledger. If off-chain, get value from an exchange or data aggregator at time of the exchange. [FAQ 27]

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Acquired Digital Assets Via Gift or Inheritance

- Gift: Generally, use giver's basis. But see §1015 and regs, FAQ 32

> A32. Your basis in virtual currency received as a bona fide gift differs depending on whether you will have a gain or a loss when you sell or dispose of it. For purposes of determining whether you have a gain, your basis is equal to the donor's basis, plus any gift tax the donor paid on the gift. For purposes of determining whether you have a loss, your basis is equal to the lesser of the donor's basis or the fair market value of the virtual currency at the time you received the gift. If you do not have any documentation to substantiate the donor's basis, then your basis is zero.

- Inheritance: Generally, FMV at date of death (§1014 and regs).

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Acquired Digital Assets

- What is the value used to record the purchase and sale where one or both digital assets traded does not have a posted value?
  - *Philadelphia Park Amusement*, 126 F.Supp. 184 (1954) – if arm's length, use the part of the transaction that does have a known or determinable value.
  - FAQ 28
- How should the taxpayer keep track of crypto activities for their records?
  - For acquisition of digital assets by cash, other digital asset, goods or services, what documentation and information reporting form might they have? [see next slide]

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FAQ 46 on Recordkeeping

Q46. What records do I need to maintain regarding my transactions in virtual currency?

A46. The Internal Revenue Code and regulations require taxpayers to maintain records that are sufficient to establish the positions taken on tax returns. You should therefore maintain, for example, records documenting receipts, sales, exchanges, or other dispositions of virtual currency and the fair market value of the virtual currency.

https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions

§6001 and regulations + §1001, et seq.

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Dispositions of Digital Assets

- Sell
- Exchange
- Donate to charity
- Gift it to a relative or transfer it upon death
- Theft – property is stolen from owner
- Abandoned by owner
- Worthlessness
- Termination of some type (for example, digital asset disappears; blockchain taken down, no one verifying transactions anymore, etc.)

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Amount Realized - Prop. Reg. §1001-7 – Computation of gain or loss for digital assets

Amount realized =

- Cash received
- + FMV of any property or services rec'd
- - transactions costs allocated to the sale or disposition of the transferred digital asset (Prop. 1.1001-1(b)(2))

- Where transaction costs arise in exchange of digital assets, treat 50% as part of acquisition (added to basis of DA acquired*) and 50% as part of disposition.
- *Prop. 1-1012-1(h)(2)
- Note - that if digital asset is used to pay transaction fee, calculate G/L on that disposition.

- https://www.govinfo.gov/content/pkg/FR-2023-08-29/pdf/2023-17565.pdf

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§1001 Example? Change in Consensus Mechanism for Digital Assets – CCA 202316008 (4/21/23)

- Appears to be directed at ETH Merge of Sept 2022
- On x date, Crypto X "changes its consensus mechanism used to select who may validate transactions and add blocks of transactions to the K blockchain from proof-of-work ("PoW") to proof-of-stake("PoS") (the "protocol upgrade")."
  - Does not affect transaction history
  - Owners continue to hold same # units
- Not an exchange under §1001 or *Cottage Savings*, 499 US 554 (1991)
  - Only affects verification of future transactions
  - Existing units unchanged
  - Nothing new obtained
- ***Query***: Isn't it relevant that PoS easier to engage in than PoW?
- ***Observations***: CCAs non-binding. Result likely is a better one on what seems to be a close call.

https://www.irs.gov/pub/irs-wd/202316008.pdf

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Basis Tracking Where Multiple Units Held and Acquired at Different Times

Virtual FAQs 39 – 41 [next slides]

Proposed Reg. 1.1012-1(h) & (j)

Issued along with Prop. Reg. 1.6045-1 (8/29/23) [next slides]

FAQs 39 – 41 on Basis Issued Oct 2019

Q39. I own multiple units of one kind of virtual currency, some of which were acquired at different times and have different basis amounts. If I sell, exchange, or otherwise dispose of some units of that virtual currency, can I choose which units are deemed sold, exchanged, or otherwise disposed of?

A39. Yes. You may choose which units of virtual currency are deemed to be sold, exchanged, or otherwise disposed of if you can specifically identify which unit or units of virtual currency are involved in the transaction and substantiate your basis in those units.

https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions

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FAQs 39 – 41 on Basis

Q40. How do I identify a specific unit of virtual currency?

A40. You may identify a specific unit of virtual currency either by documenting the specific unit's unique digital identifier such as a private key, public key, and address, or by records showing the transaction information for all units of a specific virtual currency, such as Bitcoin, held in a single account, wallet, or address. This information must show (1) the date and time each unit was acquired, (2) your basis and the fair market value of each unit at the time it was acquired, (3) the date and time each unit was sold, exchanged, or otherwise disposed of, and (4) the fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit.

FAQs 39 – 41 on Basis

Q41. How do I account for a sale, exchange, or other disposition of units of virtual currency if I do not specifically identify the units?

A41. If you do not identify specific units of virtual currency, the units are deemed to have been sold, exchanged, or otherwise disposed of in chronological order beginning with the earliest unit of the virtual currency you purchased or acquired; that is, on a first in, first out (FIFO) basis.

Proposed Regs on Broker Reporting of Digital Assets – REG-122793-19 (8/29/23)

Basis – General Observations:

- Identification of DA disposed of must be made in advance of transfer for basis reporting purposes.
- Identification must tie to DA in the same wallet.
- Specific identification approach is not considered a method of accounting.
  - Preamble: "prop § 1.1012–1(j)(4) clarifies that taxpayer's method of specifically identifying the units of a particular digital asset sold, disposed of, or transferred is not a method of accounting. This means that each time a taxpayer sells, disposes of, or transfers units of a particular digital asset, taxpayer can decide how to specifically identify those units, for example, by earliest acquired, latest acquired, or highest basis. Therefore, a change in method of specifically identifying the digital asset sold, disposed of, or transferred is not a change in method of accounting to which sections 446 and 481 apply."
- If no specific identification, default to FIFO to determine basis.
- https://www.govinfo.gov/content/pkg/FR-2023-08-29/pdf/2023-17565.pdf

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Prop. Reg. §1.1012–1(j)(1) and (2) - Basis

- Unlike FAQs that allow for (or did not disallow) a universal tracking across wallets and exchanges, the proposed S1012 regs call for tracking by wallet or exchange.
- Similar rules for DA held in unhosted wallet and DA held by broker, but for unhosted, how will taxpayer prove how they applied specific identification?
- See examples next slides.

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Prop. Reg. §1.1012–1(j)(1) and (2)

- (j)(2) [unhosted wallet] - Track within each single wallet or account. If *specific identification** not made, then FIFO applies (but date units transferred into taxpayer's wallet or account are disregarded for this purpose).
  - * "made if, no later than date and time of sale, disposition, or transfer, taxpayer identifies on its books and records the particular units to be sold, disposed of, or transferred by reference to any identifier, such as purchase date and time or purchase price for the unit, that is sufficient to identify units sold, disposed of, or transferred in order to determine basis and holding period of such units. A specific identification can be made only if adequate records are maintained for all units of a specific digital asset held in a single wallet or account to establish that a disposed unit is removed from the wallet or account for purposes of subsequent transactions."
  - *Query*: Track with your software? Send email to yourself to state what you decided? Something else?

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Prop. Reg. §1.1012–1(j)(1) and (2)

- (j)(3) [digital assets in custody of broker] – no later than time of transfer/disposition, taxpayer must provide broker with adequate identification of which units disposed of, basis and holding period, otherwise, FIFO applied to track.

- Queries: How? What will brokers require? Will tracking software help clients with this? How do you know if the tracking software matches what broker was told by client?

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Effective date for §1001 and §1012 prop regs

- Effective for all sales and acquisitions of digital assets on or after January 1 following publication of TD (final regs).
- Per preamble (page 59616) – "Taxpayers, however, may rely on these proposed regulations under sections 1001 and 1012 for dispositions in taxable years ending on or after August 29, 2023, provided the taxpayer consistently follows the proposed regulations under sections 1001 and 1012 in their entirety and in a consistent manner for all taxable years through the applicability date of the final regulations."
  - **Caution!** This statement in preamble means need to ask clients with digital assets if they want to apply the prop regs for 2023 (and 2024) or continue to follow FAQs and wait until prop regs finalized. Even though some challenges likely exist in following prop 1001/1012 regs now, arguably need to let client know of this decision available to them.

Example (1) – Prop. 1.1001-7(b)(5) - Facts

Exchange of digital assets for services

- TP owns a total of 20 units of digital asset A, and each unit has an adjusted basis of $0.50. X, an unrelated person, agrees to perform cleaning services for TP in exchange for 10 units of digital asset A. The fair market value of the services performed by X equals $10. X then performs the services, and TP transfers 10 units of digital asset A to X. Additionally, TP pays, in cash, $1 of transaction fees to dispose of digital asset A.

Example (1) – Prop. 1.1001-7(b)(5) - Analysis

Under paragraph (b)(1), TP has a disposition of 10 units of digital asset A for services received. Under paragraphs (b)(2)(i) and (b)(2)(ii)(A), TP has digital asset transaction costs of $1, which must be allocated to the disposition of digital asset A. Under paragraph (b)(1)(i), TP's amount realized on the disposition of the units of digital asset A is $9, which is the fair market value of the services received, $10, reduced by the digital asset transaction costs allocated to the disposition of digital asset A, $1. TP recognizes a gain of $4 on the exchange ($9 amount realized reduced by $5 adjusted basis in 10 units).

Example (1) – Prop. 1.1001-7(b)(5) – Modification of Facts – To Clarify Basis of UTXO

Exchange of digital assets for services

- TP owns a total of 20 units of digital asset A, and each unit has an adjusted basis of $0.50. ***TP acquired all 20 units 3 years ago in a single transaction. All 20 units are held in TP's wallet as one code.*** X, an unrelated person, agrees to perform cleaning services for TP in exchange for ***12*** units of digital asset A. The fair market value of the services performed by X equals ***$12***. X then performs the services, and TP transfers ***12*** units of digital asset A to X. Additionally, TP pays, in cash, $1 of transaction fees to dispose of digital asset A. ***When TP pays X, all 20 units of A leave TP's wallet. TP will get 8 units in change (with a new code) X will get 12 units in payment (with a new code).***

Example (1) – Prop. 1.1001-7(b)(5) – Modification of Analysis to clarify UXTO

Under paragraph (b)(1), TP has a disposition of ***12*** units of digital asset A for services received. Under paragraphs (b)(2)(i) and (b)(2)(ii)(A), TP has digital asset transaction costs of $1, which must be allocated to the disposition of digital asset A. Under paragraph (b)(1)(i), TP's amount realized on the disposition of the units of digital asset A is ***$11***, which is the fair market value of the services received, ***$12***, reduced by the digital asset transaction costs allocated to the disposition of digital asset A, $1. TP recognizes a gain of ***$5*** on the exchange ***($11*** amount realized reduced by ***$6*** adjusted basis in ***12*** units). ***There is no change to the basis of the 8 units that were returned to TP as change (remains at$0.50 per unit).***

Basis Issue – Prop 1.1012-1(j) vs. VC FAQs

From AICPA comment letter:

- "Taxpayer D acquired multiple units of digital asset XYZ (a virtual currency) over several years. Some of these units are held in Taxpayer D's personal wallet, which he alone controls, while others were acquired and held on Exchange M and the balance on Exchange N. In 2022, Taxpayer D sold 10 units of XYZ held on Exchange M. In D's digital asset records, tracked using special software designed for tracking, Taxpayer D specifically identified 10 units of XYZ held on Exchange N as the units disposed of, and Taxpayer D calculated the gain or loss accordingly (assuming these were the first units Taxpayer D acquired on Exchange N). Note that while the units were literally sold on exchange M, within the tracking software units of N were specifically identified as the ones sold (using the universal or multi-account approach allowed by the FAQs).
- This scenario, which would not be uncommon as the FAQs allowing a universal approach were issued in October 2019, means that either the taxpayer should be allowed to continue to use the treatment allowed by the tracking software that was in place before finalization of the section 6045 regulations or final regulations should explain what taxpayers should do to move from the universal approach of the FAQs to the per wallet or account approach specified in Prop. Reg. §1.1012-1(j). However, this example is used to illustrate the difference between wallet by wallet and universal methods."
- https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/2023/aicpa-comment-letter-on-proposed-6045-regulations-11-8-23-final-submit.pdf

IRS List of Questions Includes for Basis Tracking …

Federal Register, page 59616

43. Are there methods or functionalities that unhosted wallets can provide to assist taxpayers with the tracking of purchase dates, times, and/or basis of specific units of a digital asset upon the transfer of some or all of those units between custodial brokers and unhosted wallets? *See* Part II.C of this *Explanation of Provisions*.

44. Should the ordering rules for unhosted wallets be applied on a wallet-by-wallet basis as proposed, or should these rules be applied on a digital asset address-by-digital asset address basis or some other basis? *See* Part II.C of this *Explanation of Provisions*.

45. Are there any alternatives to requiring that the ordering rules for digital assets left in the custody of a broker be followed on an account-by-account basis; for example, if brokers have systems that can otherwise account for their customers' transactions? *See* Part II.C of this *Explanation of Provisions*.

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Basis – One more consideration for many California digital asset investors

- Pre-TCJA version of §1031 continues to apply to individuals filing as head of household, surviving spouse, or married filing jointly with AGI less than $500,000 and taxpayers filing as single with AGI less than $250,000 for the tax year in which the exchange begins.
  - CA Rev. & Tax. §18031.5
- Note: When customers of digital asset brokers eventually get Form 1099-DA, basis won't match CA tax information if had §1031 transactions.
  - Federal-California differences.
- Query: How are affected Californians tracking application of §1031 and determining when digital assets are like kind?

- When is a digital asset like-kind to another digital asset?

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IRS Addressed §1031 and BTC, ETH, LTC – CCA 202124008 (6/18/21) (for pre-2018 federal years)

- Issue: If completed before 1/1/18, does exchange of
  - Bitcoin for Ether
  - Bitcoin for Litecoin
  - Ether for Litecoin

  Qualify as §1031 like-kind exchange?
- Conclusion: No
- Not like-kind because different traits.
  - §1.1031(a)-1(b) "like kind" look at nature or character of the property and not the grade or quality. "One kind or class of property may not be exchanged for property of a different kind or class."
  - Bitcoin and Ether used to acquire other VCs; so different from Litecoin
  - Bitcoin and Ether differ in "overall design, intended use, and actual use"
    - Bitcoin – payments
    - Ethereum – also used for smart contracts and other applications

§1031 and BTC, ETH, LTC – CCA 202124008 (6/18/21) (for pre-2018 years)

Observations:

- Suggests traits relevant for §1031: overall design, intended use, actual use. Doesn't say that one virtual currency can never be like-kind to another. Likely, some are like-kind to Litecoin; some might be like-kind to bitcoin or Ether.
- Issue is important because §1031 is mandatory. Issue still relevant in California to most individuals.
  - See paper at https://21stcenturytaxation.blogspot.com/2021/10/crypto-and-1031-still-relevant-in.html
- We might see future federal tax cases for pre-2018 years.
- Does taxpayer's software for tracking transactions help CA taxpayers subject to §1031 with basis tracking required for §1031? Reporting on Form 8824 (not needed for federal) (does FTB require it)?

Disposition by Donation to Charity of DA Held for Investment

- §170 and regulations
  - If held over 1 year, deduction = FMV
  - Be sure to follow all documentation requirements such as contemporaneous written acknowledgement and qualified appraisal if worth over $5,000.
    - CCA 202302012 (1/13/23) – next slides

Crypto Donations Valued at More than $5,000 and Appraisal Requirement – CCA 202302012 (1/13/23)

- Facts: Individual (T) prepares own return and claims deduction of $10,000 for Cryptocurrency B donated to charity. Reported on Form 8283. Value obtained from a listing of B on a cryptocurrency exchange. T argues appraisal not needed because B has a "readily ascertainable value" shown on exchange.
- Law:
  - IRS notes §6045(g) defining digital asset, Notice 2014-21 and Rev Rul. 2019-24, AND §170(f)(11), Reg. 1.170A-13, 1.170A-16 and 1.170A-17, and related case law.

- https://www.irs.gov/pub/irs-wd/202302012.pdf

Review of §170(f)(11) on Qualified Appraisals

- §170(f)(11) Qualified Appraisal and Other Documentation for Certain Contributions
  - (A) In general
    - (i) Denial of deduction In the case of an individual, partnership, or corporation, no deduction shall be allowed under subsection (a) for any contribution of property for which a deduction of more than $500 is claimed unless such person meets the requirements of subparagraphs (B), (C), and (D), as the case may be, with respect to such contribution.
    - (ii) **Exceptions**
      - (I) **Readily valued property** Subparagraphs (C) and (D) shall not apply to cash, property described in subsection (e)(1)(B)(iii) or section 1221(a)(1), publicly traded securities (as defined in section 6050L(a)(2)(B)), and any qualified vehicle described in paragraph (12)(A)(ii) for which an acknowledgement under paragraph (12)(B)(iii) is provided.
      - (II) **Reasonable cause** Clause (i) shall not apply if it is shown that the failure to meet such requirements is due to reasonable cause and not to willful neglect. …
  - (C) **Qualified appraisal for contributions of more than $5,000** In the case of contributions of property for which a deduction of more than $5,000 is claimed, the requirements of this subparagraph are met if the individual, partnership, or corporation obtains a qualified appraisal of such property and attaches to the return for the taxable year in which such contribution is made such information regarding such property and such appraisal as the Secretary may require.

Crypto Donations Valued at More than $5,000 and Appraisal Requirement – CCA 202302012 (1/13/23) – HOLDING 1

- If claim deduction over $5,000 for contribution of cryptocurrency, must have qualified appraisal per §170(f)(11).
  - Exception for publicly traded securities uses §165(g) definition of “security”.
    - Crypto B is not a security.
    - **Qualified appraisal needed.**

Crypto Donations Valued at More than $5,000 and Appraisal Requirement – CCA 202302012 (1/13/23) – HOLDING 2

- **If appraisal required and donor fails to get one, reasonable cause exception at §170(f)(11)(A)(ii)(II) does <u>not</u> apply.**
  - Must have exercised "ordinary business care".
  - Form 8283 says qualified appraisal needed. So, even if had paid preparer, T has no reasonable cause.
  - See *Pankratz*, TC Memo 2021-26. Tax Court noted that 4 mentions of "appraisal" on Form 8283 "is pretty good notice that substantial noncash donations need to be backed up by an appraisal.""
  - "The reasonable cause exception was not intended to provide taxpayers with the choice of whether to obtain a qualified appraisal, but to provide relief where an unsuccessful attempt was made in good faith to comply with requirements of section 170. … As such, claims that B has a readily ascertainable value because it is listed on a cryptocurrency exchange does not establish reasonable cause for failing to obtain, or attempting to obtain, a qualified appraisal."

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Gift or Bequest of Digital Asset

- Regular rules for any gift or bequest should apply.
- Unique issues for digital assets:
  - Must the transfer be "on-chain" to be a valid transfer?
  - What happens if owner dies with the codes – omit from estate on assumption value zero if can't access?
- Others?

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Losses from Digital Assets

- Normal property rules should apply.
- But, there might be unique matters for digital assets that need guidance.
- First – CCA 202302011 (1/13/23) – next slides

Crypto Losses and §165 – CCA 202302011 (1/13/23)

- Issue: "If Taxpayer A owns cryptocurrency that has substantially declined in value, has Taxpayer A sustained a loss under section 165 due to worthlessness or abandonment of the cryptocurrency?"
- Conclusion: No
- Key facts:
  - A's crypto has only declined in value; still holds it.
  - Since purchased in 2022 at $1/unit, it dropped to less than 1¢/unit at 12/31/22.
    - Still traded on at least 1 cryptocurrency exchange
    - A still has control over the unit
    - On 2022, A claimed deduction under §165 that B was worthless or abandoned.

https://www.irs.gov/pub/irs-wd/202302011.pdf

Crypto Losses and §165 – CCA 202302011 (1/13/23)

Interesting items from IRS in this CCA:

- Refers to §6045(g), Notice 2014-21, Rev. Rul. 2019-24, §165 and regs and some related cases on losses.
- Loss allowed under §165(a) only if sustained.
- If worthless, §165(g) on worthless securities treated as sale or exchange of capital asset on last day of year, N/A because B is not a security as defined under §165(g).
- IF B were worthless, §67(b)(3) treats this (ordinary) loss as misc itemized deduction subject to 2% AGI limit so not allowed for 2018 through 2025 (§67(g)). [Allowed in California]
- NOT worthless if
  - Value greater than $0
  - Still traded
  - While it decreased in value, must take "some affirmative step that fixes the amount of the loss, such as abandonment, sale, or exchange." *Lakewood Assocs.*, 109 T.C. 450, 459 (1997)", 1.165-1
  - Worthlessness is question of fact.
    - Here, B still has liquidating value.

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Crypto Losses and §165 – CCA 202302011 (1/13/23)

More interesting items from IRS in this CCA:

- A took no steps to abandon crypto B including to permanently discard it from use.
- "Abandonment is proven through an evaluation of the surrounding facts and circumstances, which must show: (1) an intention to abandon the property, coupled with (2) an affirmative act of abandonment."
- "The mere intention alone to abandon is not, nor is non-use alone, sufficient to accomplish abandonment."
- "Some express manifestation of abandonment is required when the asset is an intangible property interest. *Citron*, 97 T.C. 200, 209–10, 213 (1991)" [also see Rev. Rul. 93-80]
- A "continued to exert dominion and control over" B. A still has ability to sell, exchange or otherwise dispose of B.

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Crypto Losses and §165 – CCA 202302011

Observations:

- IRS doesn't say what is and is not abandonment of crypto.
  - Law on tangible assets and traditional investments, likely not helpful because most cryptocurrency is decentralized (who do you give the coin back to).
  - Would transfer to a burner or null address where trading would end be considered abandonment?
    - Not clear as asset still exists on ledger, just can't be transferred.
      - Likely no better answer by destroying your code.
- IRS doesn't say it, BUT abandonment loss is same as worthlessness loss – not allowed under §67 through 2025. See Reg. 1.165-5(i) on abandoned securities same as worthless securities.
- If definitely want to claim loss – need to sell or exchange to generate a capital gain or loss.
- AICPA letter to IRS and Treasury seeking more guidance on crypto losses, 4/14/23
  - https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-aicpa-comments-on-digital-currency-losses-submit.pdf

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Crypto Losses and §165 – CCA 202302011

Open Issues:

- Some websites operated by someone who will buy "worthless" NFTs and cryptos for set amount of ETH worth less than 1¢
  - Query: Is this a valid sale if no negotiation on price?
- For losses via exchanges:
  - First, read terms of use or service to figure out relationship between exchange and customer.
  - Identify all customer had on exchange.
  - Watch news such as from bankruptcy trustee or law firm on what is going on.
  - Query: What if customer "loaned" crypto to exchange and can't get it back?
    - Is this a bad debt if not USD? Per Notice 2014-21, VC is non-currency property.
      - What is tax treatment when lessee doesn't return lessor's property? [later slides]
  - Was there a theft?
    - Lots to prove including intent and no reasonable prospect of recovery to claim this. But if yes, investment theft is allowed as an itemized deduction.
- Might §1234A, Gains or losses from certain terminations, apply?
  - https://www.law.cornell.edu/uscode/text/26/1234A

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Crypto Theft Issue

- Existing guidance states that for some losses such as theft, if there is a reasonable prospect of recovery, no loss can be claimed.
- What is a *reasonable prospect of recovery* for digital assets?
  - Does it depend on how assets were held (custodian, loaned, held directly, in a pool, other ways)?
  - Is taxpayer expected to hire a blockchain or distributed ledger forensic company to try to track down your crypto?
  - Wait for any related bankruptcy to be complete?
  - Anything else?
- We have case law on how this works for some non-crypto investments - see *Adkins*, 960 F3d 1352 (Fed Cir. 2020)
  - But how does this translate to crypto?

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Crypto Lending Activities

Query: What is the true nature of the transaction? Sale, interest generating activity, §1058 type activity?

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Crypto Lending Activities

- Two common types of crypto lending
  - Deposits to earn additional rewards (lender)
  - Crypto loans – allows borrower to borrow against own crypto
- What about
  - Taxpayer provides own cryptocurrency to a trade or business to provide liquidity support? (i.e. a business needs a specific cryptocurrency for business reasons and taxpayer lent it to the business as a short term loan)
  - Staking via a 3rd Party Staking Pools – similar fact patterns: 3rd party has control over private keys and have custody over taxpayer fund, taxpayer trust 3rd party to manage the staking process and pass on the staking rewards

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Crypto Lending Activities

- Possible issues to consider –
  - What is the value of crypto at the time "deposit" is made?
  - What is the value of crypto at the time "deposit" is returned?
  - When is additional rewards received and what is the value used to calculate income?
  - In the case that the value of crypto increase when the "deposited" crypto is returned, does the taxpayer have additional income because of the increase in value? (i.e. value of 10 ETH will be different today vs 1 month from now)
  - In the case of a borrower, why is it not considered a "sale" when taxpayer deposited a specific cryptocurrency as collateral and received a different type of cryptocurrency or FIAT for liquidity purposes?

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Crypto Lending Activities

- IRS Notice 2014-21 provides that convertible virtual currency is treated as “property”.
  - Is lending activity considered a type of “rental” property under Section 469?
  - Section 469(j)(8) defines the term “rental activity” as any activity where payments are principally for the use of *tangible* property.
  - Cryptocurrency is not “tangible property” therefore Section 469 only applies if the lending involved a trade or business in which individual does not materially participate.
  - Lending of cryptocurrency raises the issue of whether the return (“interest” and other revenue) is considered portfolio income or business income.

Crypto Lending Activities

- IRC Section 1058 provides that no gain or loss shall be recognized in the case when a taxpayer transfers securities pursuant to an agreement which meets the requirement of Section 1058(b).
- Per Section 1058(a), securities are defined in Section 1236(c).
- Section 1236(c) defines securities as
  - Any share of stock in any corporation
  - Certificate of stock or interest in any corporation
  - Note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.
- Will Section 1058 applies to crypto lending?

Crypto Lending Activities

- What about if the lending activities failed? (i.e. no return of any cryptocurrency…. Not even principal) will there be any bad debt loss deduction under Section 166?
- Treas. Reg. 1.166-1(c) requires a "bona fide debt" as defined as involving a "valid and enforceable obligation to pay a fixed or determinable sum of money."
- Notice 2014-21 provides that virtual currency is not money, so it appears that Section 166 does not apply.

Crypto Lending Activities

- Guidance needed on the treatment of lending of virtual currency or other digital assets under IRC Section 162, 165, 166, 469, 1001 and 1058.
- When income is received as a result of the "lending" activities, what is the character of the income? Portfolio income or business income?
- When lending activity default, what loss does it create and is it deductible? If so, under what code section?

Tax Reporting Requirements

Tax Reporting Requirements

- Income Tax Reporting: 1040, 1065, 1120, 1120S
  - Question on 1040, 1065, 1120, 1120-S, 1041, 709
  - §1031 not applicable for Federal but maybe California
    - Does FTB require Form 8824 if not included on federal return?
- Information Reporting:
  - Form 1099s – 1099-DA, 1099-K, 1099-NEC, 1099-MISC
  - Form W-2
  - FinCEN 114 (FBAR)
  - Form 8300 (to include digital assets as cash after regs issued – see next slide]

Section 6050I / Announcement 2024-4

- Section 6050I requires that any person engaged in a trade or business that receives cash in excess of $10,000 in a single transaction or in related transactions must file Form 8300 with in 15 days.
- Infrastructure Investment and Jobs Act (IIJA) expanded the definition of cash to “digital assets” under §6045(g).
- IRS delayed implementation of the reporting under §6045.
- Announcement 2024-4 provides transitional guidance under S6050I with respect to reporting transactions involving receipt of digital assets and clarifies that digital assets are not required to be included in Form 8300 filing until the Treasury Department and the IRS publishes regulations under §6050I. IR-2024-12 (1/16/24)