2021 Summer CPE Series

Cryptocurrency Taxation 101

Presented by:

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Cryptocurrency and Blockchain Overview

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Overview of cryptocurrencies

- Cryptocurrency – *a digital asset designed to work as a medium of exchange using cryptography to secure transactions, to control the creation of additional units, and to verify the transfer of assets*
- Cryptography – *the process of constructing and analyzing protocols that prevent third parties or the public from reading private messages*
- Decentralized
- Now over 5,800 cryptocurrencies listed on CoinMarketCap

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Overview of cryptocurrencies

- Blockchain – *a type of digital "general ledger" that records and validates thousands of transactions in the form of blocks*
- What gives economic value to cryptocurrencies?
- Decentralized vs. fiat currencies
- The terms coin and token are often used interchangeably when referring to cryptocurrencies, but have different functions.

Overview of cryptocurrencies

- Bitcoin vs. altcoins
- The definition of a “major” cryptocurrency will evolve over time.
- Ethereum has fought its way into the conversation.

Overview of cryptocurrencies

- Exchanges – *marketplaces, whether regulated or unregulated, used to transfer or trade coins and tokens*
  - Over 300 active exchanges listed on CoinMarketCap
  - Not all exchanges offer access to all actively traded cryptocurrencies
- Wallet – *application that allows cryptocurrency users to store and to retrieve digital assets*
  - Private vs. public keys
  - Hot vs. cold storage
- Custody considerations

Polling Question #1

What is the most recent tally of cryptocurrencies with a listing on CoinMarketCap?

- A - Over 500
- B - Over 3,000
- C - Over 5,000
- D - Over 50,000

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Overview of cryptocurrencies

- How are transactions validated?

- Consensus protocol – *mechanism used in blockchain systems to achieve the necessary agreement on a single data value*
  - The two prevalent protocols in cryptocurrency are proof of work and proof of stake.
  - In addition to these protocols being critical for validation, they also determine what rewards participants receive for maintaining the stability of the blockchain.
  - Rewards may include the collection of a transaction fee, also referred to as “gas” on the Ethereum blockchain, newly created coins or tokens, or both.

Overview of cryptocurrencies

- Proof of work
  - “Mining”
  - Uses raw computing power to solve complex cryptographic problems
  - Computing capacity is the measure of influence

- Proof of stake
  - “Staking” or “minting”
  - Uses a consensus protocol that rotates randomly among users, or “nodes,” with staked cryptocurrency in proportion to the amount of cryptocurrency staked
  - Amount of staked cryptocurrency is the measure of influence

Overview of Cryptocurrencies

Proof of Work	Proof of Stake
▪ Advantage – Less vulnerable to attacks and less prone to forking due to the resources involved ▪ Disadvantage – Consumes a tremendous amount of energy	▪ Advantage – Lower resource requirements encourage participation and lead to less energy consumption ▪ Disadvantage – May be more prone to low-cost attacks on nodes

Overview of cryptocurrencies

- ICOs (initial coin offerings) and SAFTs (simple agreement for future tokens)
  - Tools for blockchain startups to raise capital
  - Investors can gamble on a new cryptocurrency at a discounted rate
  - Capital typically raised in Bitcoin or Ethereum
  - The SAFT was generally regarded as the preferred method for ICOs soliciting U.S. investors as it is believed to be SEC-compliant
- Many ICOs and SAFTs from the initial wave are now coming to fruition.
- ICOs and SAFTs are still occurring though decentralized finance has expanded in ways that provide a greater diversity of blockchain investment opportunities.

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Overview of cryptocurrencies

- Smart contracts
  - If X & Y happen in the blockchain, Z is initiated
  - Ethereum-based

- Regulatory considerations
  - CTFC and SEC
  - ICOs
  - Unregulated exchanges
  - Taxation

Polling Question #2

Which of the following statements regarding cryptocurrency validation and rewards is untrue?

- A – Cryptocurrencies commonly use proof of work or proof of stake consensus protocols.
- B – Proof of work mining is notorious for its consumption of electricity.
- C – Proof of stake validation has a lower barrier to entry because it does not require as much raw computing power as proof of work mining.
- D - Participation in mining or staking can be lucrative, but those activities are not critical to the function of a blockchain.

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Cryptocurrency Taxation Issues

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Cryptocurrency taxation issues

- Available IRS guidance
  - Notice 2014-21
  - Rev. Rul. 2019-24 and IRS FAQs
  - CCM 202114020
  - ILM 202124008

- These items answer some questions regarding the taxation of cryptocurrency, but leave many others as “gray areas.”

- Reasonable application of existing rules and regulations is required when current guidance is lacking.

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Cryptocurrency taxation issues

- How is cryptocurrency classified for U.S. tax purposes?
  - Property, not currency
  - Commodity vs. security

- What is the tax character of cryptocurrency?
  - Capital asset (unless held as inventory)
  - Capital asset rules for tracking basis and holding period should apply
  - Uncertainty in exactly how cryptocurrency is classified leaves open questions on various issues such as lot relief, applicability of wash sale rules and other anti-deferral provisions, and the treatment of lending

Polling Question #3

Which of the following classifications definitely does not apply to cryptocurrency and digital assets in the view of the IRS?

- A – Currency
- B – Property
- C – Commodity
- D – Security

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Cryptocurrency taxation issues

- Special acquisition issue - forks and airdrops
  - The receipt of a new cryptocurrency from a hard fork or an airdrop will generally be taxed as ordinary income based on its fair market value.
  - “Dominion and control”

- Disposition issues
  - Sales for fiat or a different cryptocurrency
  - Gifts
  - Payments for services

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Cryptocurrency taxation issues

- Investing partnerships
  - Should cryptocurrency be included in assets used to determine whether an entity is a qualifying investment partnership for Sec. 704(c)?
  - What about investing/trading safe harbors for Sec. 864?

- Other partnership considerations
  - In-kind contributions of cryptocurrency
  - In-kind distributions of cryptocurrency
  - Withholding

Cryptocurrency taxation issues

- Information reporting
  - Form 1099-MISC or Form 1099-NEC
  - Form W-2
  - FATCA & CRS
  - FBAR (FinCEN Form 114)

- Compliance risks and consequences
  - Box on Form 1040 requiring disclosure of cryptocurrency transactions
  - Underpayment penalties

Cryptocurrency taxation issues

- Emerging trends in cryptocurrency means more tax issues to consider.
- Expansion of decentralized finance (“DeFi”) networks
  - Lending, borrowing, liquidity provision, yield farming, and the use of stablecoins are just a sample of these activities over and above mining/staking.
  - DeFi tax considerations
    - Hybrid between passive activities and providing/acquiring a service
    - Sourcing the activity to a jurisdiction
    - Trade/business income (dealer issue?) or investment income
    - Unique issues with lending of cryptocurrency
    - Impacts on U.S. investors and foreign investors
- Emergence of non-fungible tokens (NFTs)
- Other emerging issues

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Polling Question #4

Which of the following with respect to cryptocurrency taxation is most accurate?

- A – DeFi platform activity has little chance of being classified as trade or business.
- B – The addition of a cryptocurrency-specific question to the Form 1040 increases the risks to taxpayers who do not report cryptocurrency transactions properly.
- C – A coin received in a hard fork for which a taxpayer does not have dominion and control will be taxed immediately anyway.
- D – None of these statements are true.

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Questions?

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