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Generations Summer 2022 - The Taxation of Cryptocurrency: Oversight on the Horizon

Tax authorities are beginning to regulate cryptocurrency in the absence of meaningful Congressional legislation or monetary policy. Revenue agencies, crypto owners, and observers do not always agree on how crypto fits into existing tax laws, which lack even basic crypto terminology. Still, the IRS and state governments will examine crypto transactions for all federal and state tax purposes, applying existing legal principles that might not be a perfect fit.

Crypto owners should carefully examine their crypto holdings and potential crypto transactions to determine how the existing rules apply and to prepare for any legal challenges.

In March 2022, President Biden ordered executive agencies to study the risks and benefits of digital assets and their underlying technology. Soon after, the Department of Labor warned retirement plan fiduciaries that crypto investment options may not meet plan fiduciaries' standards of care, and Treasury Department Secretary Yellen called for a comprehensive policy to contain risks associated with crypto in association with the U.S. dollar.

In spite of these developments, the Treasury has not issued substantive crypto regulations other than regulations that require enhanced reporting requirements.

Without formal rules from the Treasury, taxpayers must rely on existing IRS pronouncements, including Notice 2014-21 and Revenue Ruling 2019-24. These pronouncements provide the framework for the IRS's responses to Frequently Asked Questions (FAQs) about crypto published on its website. These crypto FAQs are meant to assist taxpayers in fulfilling their tax reporting obligations but do not carry the force of law.

The FAQs generally follow these accepted tax principles: 1) taxpayers must recognize the fair market value of virtual currency received in exchange for property (including other crypto) or services in their gross income; 2) the initial cost basis of virtual currency is the fair market value paid for such currency in U.S. dollars; 3) the character of gain or loss on a sale or exchange of crypto depends on whether the crypto is a capital or ordinary asset in the taxpayer's hands; and 4) taxpayers who donate crypto or receive crypto as a gift generally should not recognize income, subject to charitable deduction limitations.

The FAQs do not, however, provide complete clarity on a range of important issues. The FAQs state that "virtual currency," including crypto, is "property" for federal income tax purposes but also observe that virtual currency that is convertible into U.S. dollars may be treated as "money." The potential treatment of crypto as both "property" and "money" is one example of how current instructions may produce conflicting tax results under different facts.

For instance, paying a service provider in crypto may generate a gain or loss to the payor, based on a deemed sale of the crypto used to pay for the service. Thus, the payor could recognize taxable gain on the difference between the crypto's fair market value on the date of payment less the payor's cost basis. This result is inconsistent with treating crypto as "money" and may create significant tax liabilities for taxpayers using crypto to pay for goods or services.

Moreover, the FAQs on the IRS website have not kept pace with the emergence of new crypto technology and assets that carry different rights and utilities. In a recent case, *Jarrett v. United States*, the IRS determined that taxpayers Joshua and Jessica Jarrett had unreported income from a "staking" transaction—a form of crypto mining on the blockchain. The IRS's determination was likely based on IRS Notice 2014-21, which states that crypto mining is a taxable event.

Mining is a form of blockchain validation that rewards miners with crypto tokens for solving a complex mathematical puzzle. Staking is a way of earning rewards for holding certain crypto—you "stake" what you own for a chance to earn more. Staking is different from mining because the "stakers" or "validators" must own the crypto tokens they seek to create before they participate.

The Jarretts, who engaged in staking, paid the amount of tax the IRS determined was due and sued for a refund. They argued that staking is like baking a cake or writing a book—the baker or author is not taxed until the work created from the effort (in this case, a crypto token) is sold. They also argued that the new tokens they received in the staking transaction were not paid to them by a "person" as currently defined by federal tax laws.

In response, the Department of Justice offered the Jarretts a full refund, probably to avoid unfavorable precedent in this new realm. The Jarretts rejected the refund and are now requesting declaratory relief to enjoin the government from making the same arguments in future tax years against the Jarretts or other taxpayers. Crypto industry *amicus curiae* have filed briefs in support of the Jarretts' request.

The *Jarrett* case highlights two important points: (1) taxpayers must maintain sufficient documents to support their crypto positions under audit and in federal court, where IRS determinations are presumed to be correct and taxpayers bear the burden of proving otherwise; and (2) the IRS's informal guidance is no substitute for congressional legislation or formal Treasury regulations subject to proper notice and comment procedures.

Without formal rules for crypto, crypto owners should presume their crypto holdings are subject to existing tax rules, including international information return reporting. Because crypto is increasingly held through non-U.S. funds or custodians, investors must identify the applicable international information reporting requirements (i.e., Foreign Bank Account Reporting, Specified Foreign Financial Asset reporting, Passive Foreign Investment Company reporting, and Controlled Foreign Corporation reporting) for foreign crypto holdings. This reporting likely applies both to "offshore" crypto holdings (e.g., crypto custodied by an offshore broker or institution) and interests in offshore crypto funds, which are becoming increasingly popular with sophisticated U.S. crypto investors. There are extremely steep penalties for failing to report offshore financial assets and accounts (as much as 50 percent of the value of the unreported assets), and the statute of limitations for assessment (generally three years) of an investor's entire tax return does not begin to run until all foreign information reports are filed.

Therefore, U.S.-based crypto owners must regularly gauge their level of exposure for both penalties and tax.

Specifically, U.S. persons who own non-U.S.-based crypto assets or fund interests are encouraged to engage qualified U.S. tax counsel to provide advice regarding federal tax planning for these investments. For example, without proper structuring in place, crypto held through an offshore vehicle or fund that constitutes a Passive Foreign Investment Company (PFIC) could be subject to a 50 percent or greater effective U.S. tax rate (plus additional penalties if the asset is not properly reported on one or more of the required international information returns normally submitted with a U.S. federal tax return).

Further, crypto owners engaging in complex transactions using financial instruments or derivative contracts should consider tax consequences before entering into deals using crypto. Recall that the IRS views crypto as "property" and not as a security, like stock in a corporation. Therefore, an exchange of crypto in a lending or swap transaction could be characterized as a taxable sale or exchange under current IRS guidance.

Finally, crypto owners are advised to consider their crypto holdings in their estate and gift planning. This includes planning not only for access to and succession of the assets in the event of disability or death but also to lessen the impact of the federal gift and estate tax imposed on U.S. persons' worldwide assets at a rate of 40 percent of fair market value (to the extent worldwide taxable gifts plus assets owned at death are in excess of the federal lifetime applicable exclusion amount of $12,060,000 per person for 2022). This includes carefully tracking cost basis, recording passwords for digital assets in estate planning documents, and considering sophisticated strategies such as funding trusts or making lifetime gifts of crypto assets to reduce U.S. federal gift and estate taxes. Many "traditional" estate planning attorneys are unfamiliar with the intricacies of planning for crypto assets; therefore, crypto owners are encouraged to seek counsel with an understanding of tax planning for crypto ownership.

The principles above also generally apply in determinations by state taxing authorities.

The taxation of crypto transactions may differ from state to state, especially in states that do not conform to federal tax laws. Although federal taxable income is generally the starting point for computing state taxable income, taxpayers must be prepared to classify crypto income as business or nonbusiness income and also address state rules for apportioning income. Without explicit federal or state laws in place, taxpayers must develop their own reporting positions and be prepared to defend them on audit.

Consequently, the taxation of crypto and crypto-like assets, such as non-fungible tokens (NFTs) and crypto derivative contracts, is largely unregulated and subject to specific fact-based determinations. The taxation of crypto largely depends on who holds the crypto, how it is held, and when. Different tax outcomes may arise depending on whether crypto is held by a creator, a dealer, a non-dealer, an investor, or a personal seller. For example, NFTs may be taxed as capital assets or as "collectibles"—although the current definition of "collectibles" does not include "intangible" assets like NFTs.

Despite the uncertainty, the U.S. government has expressed clear interest in collecting information regarding crypto transactions. The 2021 Infrastructure Investment and Jobs Act created enhanced reporting requirements, and the Treasury's Financial Crimes Enforcement Network (FinCEN) has indicated that virtual currency may soon be subject to Foreign Bank and Financial Account (FBAR) reporting requirements. The IRS has issued John Doe summonses to crypto exchanges such as Coinbase to identify crypto owners and has expanded its Voluntary Disclosure Programs to allow taxpayers to disclose unreported transactions in virtual currency and avoid criminal prosecution.

In recent weeks, Congress has proposed granting primary regulatory authority over crypto to the Commodities Futures Trading Commission (CFTC), which considers crypto a commodity. This could potentially result in regulatory overlap between the CFTC and the IRS—adding extra compliance burdens for crypto owners.

In light of these developments, crypto owners are strongly advised to consult with a qualified tax professional to fully understand the existing rules and tax uncertainties surrounding crypto before they engage in sophisticated transactions. Also, it is clear that ignorance of the law and "burying one's head in the sand" will no longer be excusable by the IRS as reasonable cause for failure to comply with all existing U.S. federal tax and information reporting laws.

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