Taxation of Pooled Cryptocurrency Investment Vehicles

By Andrea S. Kramer and Nicholas C. Mowbray*

Andrea S. Kramer and Nicholas C. Mowbray describe and examine the taxation of direct investments in cryptocurrency, derivatives, and pooled investment vehicles that invest in cryptocurrencies.

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Retail and institutional interest in cryptocurrencies is booming and so is interest in exchange-traded funds ("ETFs"). Nevertheless, there is no combination of the two in the United States. In this article, we look at the tax reasons why there is no such product and examine the taxation of direct investments in cryptocurrency, derivatives, and pooled investment vehicles that invest in cryptocurrencies. In particular, we focus on the uncertain tax status of cryptocurrency, whether arguments exist to support its qualification as a security or commodity for tax purposes, and the uncertainty that results due to inaction from the Treasury Department, the Internal Revenue Service ("IRS"), and Congress on the tax status of cryptocurrencies.

The subject of the taxation of cryptocurrencies, ETFs, and other types of pooled investment vehicles is complicated by the fact that the IRS, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") define many key terms differently. To complicate things further, the popular press uses many of these terms in inconsistent and imprecise ways. Therefore, to sort out the taxation of cryptocurrencies and pooled investment vehicles, we must work with terms that mean different things in different contexts. To avoid this confusion, we will use key terms in this article in the following ways.

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Key Words and Phrases

- We use "cryptocurrency" and "virtual currency" interchangeably. The IRS and CFTC tend to use the term "virtual currency," the SEC generally uses "digital assets," and the popular press almost always uses "cryptocurrency."
- The popular press refers to most publicly traded pooled investment products as ETFs, without regard to how the funds are structured or taxed. When

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referring to ETFs in this article, however, we will be referring exclusively to pooled investment vehicles that are traded on securities exchanges; registered as investment companies under the Investment Company Act of 1940; and taxed at the federal level as regulated investment companies ("RICs").

- The other popular pooled investment vehicles we will discuss are grantor trusts and partnerships. Both of these vehicles can be publicly traded or privately held. If they are publicly traded, investors can purchase and sell interests in them on the open market. If they are privately held, the only way to acquire or dispose of such interests is in accordance with the contractual provisions in the vehicle's organizational documents. A hedge fund is a type of pooled investment vehicle that is privately held. When hedge fund investors are U.S. taxable investors, the hedge fund is typically structured and taxed as a partnership. Partnerships are generally taxed as flow-through entities unless they are publicly traded ("PTPs"), in which case they are taxed as corporations *unless* the PTP meets an exemption based on the type of income it generates.
- The Supreme Court has held that "securities" for purposes of the securities laws includes, in addition to stocks, debt investments, and derivatives on stock and debt instruments, all investments in a "common enterprise with profits to come solely from the efforts of others."[1] Under the Internal Revenue Code of 1986, as amended ("Code"), however, the term "securities" has a much narrower meaning, varying with the specific Code provision involved.
- The Commodity Exchange Act ("CEA") defines "commodity" broadly to include certain enumerated agricultural products and "all other goods and articles," and "all services, rights, and interests … in which contracts for future delivery are presently or in the future dealt in."[2] The CFTC enforces the CEA. As we discuss in this article, the IRS's definition of a "commodity" is not altogether clear, but there is strong authority to suggest that for tax purposes, a commodity follows the same broad definition as in the CEA.

Investor Interest

Investors have flocked to ETFs. During the first four months of 2021, there were net inflows into ETFs of $332 billion.[3] This puts 2021 on track to surpass the 2020 record of $503 billion net inflows to ETFs.[4] Such strong investor interest is not surprising, given the ease with which investors can buy and sell interests in ETFs, the variety of investment strategies offered by ETFs, and the variety of asset classes they offer, some of which were previously unavailable to retail investors.[5] There has been a similar boom in both retail and institutional interest in cryptocurrencies. During the first four months of 2021, major crypto exchanges reported trading of $1.7 trillion, up from less than $100 billion through April of 2020.[6]

Because the tax treatment of RICs is inconsistent with holding a significant amount of cryptocurrencies, there are no cryptocurrency ETFs. As a result, investors interested in pooled cryptocurrency products must look elsewhere. Currently there are three types of pooled cryptocurrency investment products: grantor trusts both publicly traded and privately held, hedge funds, and PTPs that have qualifying income (resulting in the PTP being taxed as a partnership).[7] All of these vehicles are structured as flow-through entities for tax purposes so that there is no taxation at the entity level. The investors are, thus, subject to direct taxation on the entity's earnings.

In what follows, we examine the tax rules for RICs that prevent ETFs from holding significant amounts of cryptocurrency. We then examine the taxation of other types of pooled investment vehicles, and we explain why their tax rules create certain limitations, uncertainty, and inefficiencies to their investment strategies.

The Structure of ETFs

ETFs, as we use the term, are registered with the SEC as open-end investment companies (mutual funds) under the Investment Company Act. They are, however, exempt from a number of requirements that normally apply to such funds.[8] ETFs are attractive investment vehicles for several reasons:

- First, ETFs have greater liquidity than many other types of pooled investment products. For example, unlike investors in typical mutual funds, investors in ETFs can purchase and sell their shares directly on an exchange market, rather than having to deal with the fund itself. And unlike some grantor trusts and hedge funds, investors can sell their ETF shares at any time.
- Second, ETFs enter into agreements with large institutional investors and broker-dealers to serve as authorized

participants ("AP"). APs create ETF shares by contributing a *pro rata* basket of the assets that make up the ETF portfolio ("creation shares"). APs also reduce the number of outstanding ETF shares by buying their shares for a basket of the assets held by the ETF. Because APs are the only shareholders that can trade directly with ETFs, and they do so exclusively on an in-kind basis, ETFs—unlike other mutual funds—do not need to hold cash or sell appreciated securities for share redemptions.

- Third, ETF shares are bought and sold at the current market price as set in public trading. The market price is not necessarily the same as the net asset value ("NAV") of the fund's portfolio. If there is a price discrepancy between an ETF's market price and its NAV, however, arbitrageurs can step in and bring the ETF's market price in-line. By contrast, other mutual funds only allow investors to buy and sell their shares in transactions with the fund at the NAV calculated at the end of a trading day.
- Fourth, ETFs are more tax efficient than other investment companies because they only need to sell appreciated assets when they must rebalance their portfolios. This is because the great majority of the time, ETFs dispose of their appreciated assets through in-kind redemptions with an AP, which is not a taxable event.[9]
- Fifth, because ETF shares are traded and priced on public exchanges, shareholders have a much better opportunity to determine the precise price at which they will purchase or sell their ETF shares than do shareholders in other types of investment companies. Shareholders in other types of investment companies can buy and sell only at NAV calculated at the end of a trading day.

The Taxation of ETFs[10]

ETFs, as we are using the term, must elect to be taxed as RICs in accordance with Code Secs. 851 through 860. As a result, they pass through their net income and gains to investors without taxation at the entity level.[11] To qualify as a RIC, the entity first must be taxed as a corporation.[12] Next, it must elect to be treated as a RIC for the current taxable year, or it must have made the election in a previous taxable year. Third, it must meet the following requirements as to the types of gross income it earns, the types of assets it holds, and the concentration of its assets.

- *Gross Income Test*: At least 90 percent of the RIC's gross income must be derived from dividends, interest, security loans, gains from sales or dispositions of securities, gains from sales or dispositions of foreign currencies, or other income (including gains from options, futures, or forward contracts) derived from investing in stock, securities, currencies, or certain "qualified" PTPs.[13]
- *Asset Test*: As of the close of each quarter, at least 50 percent of the value of the RIC's total assets must be represented by cash, cash items, government securities, securities of other RICs, and corporate securities. In addition, the RIC's total investment in a single corporation cannot exceed five percent of the value of that corporation's total assets or constitute more than 10 percent of its voting securities.[14]
- *Asset Diversification Test*: Not more than 25 percent of the value of the RIC's total assets can be invested in (1) the securities of any one issuer; (2) the securities (other than securities of another RIC) of two or more issuers that the RIC controls that are engaged in the same or similar trade or business; or (3) the securities of one or more qualified PTPs.[15]
- *Distribution Test*: The RIC must distribute 90 percent of its income as dividends in the current tax year, and either the RIC was subject to the RIC tax provisions for all tax years ending on or after November 8, 1983, or as of the close of the current taxable year, the RIC has no earnings and profits accumulated in any taxable year in which the RIC was not subject to the RIC provisions.[16]

An ETF's ability to invest in cryptocurrencies is severely limited because of the Gross Income Test, the Asset Test, and the Asset Diversification Test. The Gross Income Test limits the types of income a RIC can earn to income streams not typically produced by direct ownership of cryptocurrencies (that is, dividends, interest, and gains from the disposition of foreign currencies and securities). As we will discuss shortly, cryptocurrencies, at least those that are convertible, are not likely to be classified as "securities" or currencies[17] for tax purposes. Furthermore, the Asset Test and Asset Diversification Test limit a RIC's investment in entities (such as a corporation or qualified PTP) that may be able to convert impermissible income streams (such as, gains on sales of commodities) into permissible income instream (such as, dividends or gains on the sale of securities). Nevertheless, what follows are examples of creative ETF designs that preserve RIC status while also seeking indirect exposure to cryptocurrency.

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ETFs and Cryptocurrencies

The first example of a creative ETF design is the Simplify U.S. Equity PLUS GBTC ETF ("Simplify Equity Fund").[18] It is structured as a RIC and does not invest directly in cryptocurrencies. Rather, it provides retail investors with limited exposure to cryptocurrency by investing less than 15 percent of its total assets in the Grayscale Bitcoin Trust (the "Grayscale Trust").[19] The trust interests are held by the Simplify Equity Fund through a Cayman Islands subsidiary of the Simplify Equity Fund.[20] The remainder of the fund's assets is invested in stocks. Because the Cayman Islands subsidiary is taxed as a controlled foreign corporation under Code Sec. 957, any income the fund receives from its subsidiary flows through to the ETF investors as ordinary income, not capital gain.

A second example is seen in the June 7, 2021 registration statement that the Volt Bitcoin Revolution ETF ("Volt ETF") filed with the SEC, which is still pending at the date of this writing.[21] The Volt ETF represents that it intends to elect RIC status but still provide investors with exposure to cryptocurrencies by investing in companies that hold bitcoin. The ETF does not intend to hold direct bitcoin investments itself, but will invest in companies with significant exposure to bitcoin. The ETF will accordingly provide its investors with the ability to make an indirect investment in bitcoin. This is much like investors in gold mining companies having an indirect investment in gold.

A third example is the June 10, 2021 submission by Invesco with the SEC for authorization to open two ETFs that will hold cryptocurrency-linked equities. About 85 percent of the capital of the proposed Invesco Galaxy Blockchain ETF and the Invesco Galaxy Crypto Economy ETF will be in crypto-linked equities, and the remainder of their assets "will be in other trusts and funds that hold cryptocurrencies."[22] Several other ETF applications are pending with the SEC at the date of this writing, seeking various types of cryptocurrency exposures.

The Regulation and Taxation of Hedge Funds

Unlike a RIC, a hedge fund is not subject to rigid gross income or asset tests. As a straightforward partnership, a hedge fund has significant flexibility in the assets in which it can invest, which includes cryptocurrency.[23] The Code does not define what a hedge fund is and it does not have a special entity level tax regime dedicated to hedge funds. Rather, it is a term that broadly applies to partnerships with pooled capital, typically from high-net worth individuals and large institutions. Its investors must be either "accredited investors"[24] or "qualified purchasers,"[25] which is a higher standard than that for accredited investors. The type of investor acceptable to the hedge fund determines the exemption it relies on from the Investment Company Act. Further, the fund cannot solicit investors. In addition, many hedge funds have minimum investment requirements (such as requiring investments of at least $100,000 or more), which makes hedge funds inaccessible to many small and retail investors.

Hedge funds that primarily trade commodity futures and options on futures can also be subject to CFTC regulation as a "commodity pool," and its advisors subject to regulation as a "commodity pool operator."[26] A commodity pool must register with the CFTC and comply with registration, disclosure, and reporting requirements.[27] Commodity pool operators typically strive for reduced disclosure, reporting, and record-keeping requirements by limiting pool participants to "qualified eligible participants" (that is, investment professionals such as brokers, dealers, future commission merchants, and individuals that meet specified net worth or income requirements).[28] This also makes commodity pools inaccessible to many retail investors.

How a hedge fund is taxed depends on how it is structured, which typically turns on the profile of the fund's investors (that is, whether they are U.S. taxable investors, non-U.S. investors, or tax-exempt investors). U.S. taxable investors generally invest in domestic limited partnerships, and they directly receive a distributive share of the fund's income, gain, loss, deductions, and credits.[29] In addition, the character of its income passes through to its partners.

Although a hedge fund can be tax efficient for investors, its large minimum investment requirements make hedge fund investments unavailable to most retail investors.

Taxation of PTPs

A PTP is a partnership with interests that are traded on an established securities market, are readily tradable on a secondary market, or are readily tradable on the substantial equivalent of a secondary market.[30] A PTP allows its investors to purchase and sell their partnership interests in the market, rather than having to deal with the

partnership itself. A PTP is taxed as a corporation *unless* the PTP meets a qualifying income test ("Qualifying Income Test") or it is exempt from this test under a grandfather provision.[31]

The Qualifying Income Test requires that 90 percent or more of the PTP's gross income meet one of two requirements. The income must either be passive income (that is, interest and dividends) or related to activities involving real estate, natural resources, or commodity trading (including the purchase and sale of futures, forwards, and options written on commodities).[32] Congress viewed PTPs with qualifying income as exchange-traded investment vehicles for individual investors to provide them with alternatives to direct participation in real estate, natural resources, and commodities. PTPs are available to individuals that want to invest in these activities but lack the expertise or ability to directly participate in these markets.

The definition of a "commodity" for purposes of the Qualifying Income Test is critically important in determining whether cryptocurrency can be held by a PTP without the PTP being taxed as a corporation. The Code and Treasury regulations do not elaborate on what constitutes a commodity for purposes of the Qualifying Income Test. The legislative history, however, provides that qualifying income was intended to include "typical commodity pools," a broad term that may signal that the term "commodity" is intended to carry its normal broad meaning.[33] Thus, while it is not free from doubt, assets over which the CFTC has regulatory jurisdiction are likely to be considered to be commodities for purposes of the Qualifying Income Test.[34]

Taxation of Cryptocurrencies

At the date of this writing, the IRS has provided limited guidance as to the tax treatment of cryptocurrencies, referred to by the IRS as "virtual currencies." The IRS first expressed its view in Notice 2014-21[35] and its accompanying Frequently Asked Questions, most recently updated in March of 2021. The IRS takes the position that convertible cryptocurrency is property—not foreign currency—and that the general tax principles that apply to property transactions govern the tax treatment of convertible cryptocurrency. This means that convertible virtual currency does not qualify as foreign currency for purposes of the RIC gross income test.

Although the IRS issued guidance in 2019 addressing hard fork transactions and air drops, it has not issued any guidance as to whether none, some, or all cryptocurrencies are taxed as securities, commodities, or something else entirely. As a result, taxpayers must rely by analogy on the tax treatment of similar products.[36]

Convertible Cryptocurrencies Are (Probably) Not Securities for Tax Purposes

The phrase "stock or securities" appears in various Code sections. In some places it appears without a definition or explanation of its intended meaning.[37] In other places, it is defined with respect to application to a specific Code section.[38] In all of the Code sections addressing "stock or securities," however, the term "stock" is limited to shares of stock. As a result, units of virtual currency and crypto derivatives are not "stock" for tax purposes.

But what about virtual currency falling within the term "securities"? Securities typically refer to debt securities, such as notes, bonds, debentures, and other evidences of indebtedness. There are, however, some Code provisions that define "securities" more broadly. For example, under Code Sec. 1236, a securities dealer can hold securities in an investment account, with "securities" defined as notes, bonds, debentures, evidences of indebtedness, *or any evidence of an interest in or right to subscribe to or purchase any of the foregoing products*.[39] Thus, a security dealer's investment account can include options, warrants, and stock rights. But under this expanded definition, the term "securities" does not include virtual currency units or derivatives.

The term "securities" also appears in the wash sale rules under Code Sec. 1091. Neither Code Sec. 1091 nor the Treasury regulations issued under it define "security." In *Gantner*,[40] the court was asked to determine whether stock options were securities for purposes of Code Sec. 1091. The taxpayer in *Gantner* purchased exchange-traded call options on stock, sold those options at a loss, bought identical stock options within the time period prohibited under Code Sec. 1091, and deducted the losses on the sale of the options. The IRS denied the taxpayer's deduction, asserting that the loss and the subsequent purchase were a wash sale.[41]

The Tax Court in *Gantner* disagreed with the IRS, holding that options did not fall within the plain meaning of the wash sales rule.[42] In reaching this conclusion, the Tax Court examined the legislative history to determine congressional intent when the wash sales rule had been enacted in the 1920s.[43] The Tax Court noted that when

the wash sale rule was enacted, there was not a significant stock options market, and after stock options starting trading, Congress had not subsequently amended the wash sales rule to include stock options in the definition of securities.[44]

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After *Gantner*, Congress promptly amended the wash sales rule to expand its scope to include "contracts or options to acquire or sell stock or securities."[45] Interestingly, Congress did not amend the definition of "securities" in enacting this change. It appears appropriate to conclude, based on *Gantner*, that because cryptocurrencies were never considered by Congress when it enacted *any* of the Code provisions that refer to "securities," it did not intend them to be included in the meaning of securities. Therefore, Congress would need to enact legislation specifically stating that cryptocurrency is a security for tax purposes. Not having done so, it is difficult to conclude that they are.

Convertible Cryptocurrencies Are (Probably) Commodities for Tax Purposes

The CEA regulates transactions in and derivatives on commodities as well as markets on which they are traded. The CFTC asserts jurisdiction over transactions involving certain cryptocurrencies on the ground that these cryptocurrencies fall within the definition of "commodities" in the CEA. In the CEA, commodity is defined to include specific enumerated agricultural products "and all other goods and articles … *and all services, rights, and interests … in which contracts for future delivery are presently or in the future dealt in.*"[46] Because "contracts for future delivery" currently trade on two convertible virtual currencies (bitcoin and ethereum), the CFTC treats those cryptocurrencies as commodities for CEA purposes.[47]

Many tax commentators take the position that if a product is a commodity for CFTC purposes, it should also be treated as a commodity for tax purposes. This is based on various tax interpretations. First, the legislative history to Code Sec. 7704 says that the definition of qualifying income (which is relevant for PTPs being exempt from taxation as corporations) was intended to include "typical commodity pools."[48] Thus, the way in which commodities are generally defined for CFTC purposes should carry significant weight for, at a minimum, Code Sec. 7704.

Second, under Code Sec. 864(b)(2)(B), trading in commodities that are "of a kind customarily dealt in on an organized commodity exchange" qualifies for a safe harbor from being taxed as a U.S. trade or business. The IRS interpreted Code Sec. 864(b)(2)(B) in Rev. Rul. 73-158, stating, that the term commodity is used "in its ordinary financial sense and includes all products that are traded in and listed on commodity exchanges located in the United States."[49] The fact that a commodity is to be understood for tax purposes in its "ordinary financial sense" is supported by a private letter ruling interpreting Code Sec. 864(b)(2)(B). In LTR 8540033, the IRS said it views an item as a commodity if it is traded on a CFTC-regulated exchange.[50] Thus, at least for purposes of Code Sec. 864(b)(2)(B), cryptocurrencies are commodities for tax purposes where they are "of a kind customary dealt in on an organized exchanged."

Third, support is also found in the broker reporting rules. Under Treasury regulations, a commodity is defined as "any type of personal property or an interest therein" in which "the trading of regulated futures contracts … has been approved by the Commodity Futures Trading Commission."[51] Such language also suggests that the Treasury views the CFTC's commodity definition as determinative for tax purposes.

The term commodity is defined even more broadly in Code Sec. 475, which allows commodity dealers and traders to elect into mark-to-market. The election into mark-to-market defines commodity to include any commodity that is actively traded for purposes of the straddle rules, including physical commodities, derivative instruments in any commodity, and evidences of interests in any commodity.[52] Evidence of interests include any option, forward contract, futures contract, short position, or any similar instrument in a commodity.[53] The term commodity also includes a position that is not itself a commodity *if* the position serves as a hedge of a commodity. Treasury

regulations under Code Sec. 1092 provide that the actively traded standard requires an established financial market, ranging from an interdealer market to an established financial market.[54]

References to a "commodity" in all of these provisions provide significant comfort that those convertible cryptocurrencies on which regulated futures contracts (or nonequity options) trade should constitute commodities for tax purposes. As of the date of this writing, however, futures and nonequity options trade only on bitcoin and ethereum, leaving uncertain the status of many thousands of other cryptocurrencies.[55]

Alternatives to ETFs for Pooled Cryptocurrency Investments

An ETF that qualifies as a RIC is in the business of investing in stocks, securities, or foreign currencies, not commodities. As long as convertible cryptocurrencies are taxed as property and commodities—not foreign currency—it is impossible for an ETF to be structured as a RIC if it holds more than an insignificant amount of cryptocurrency.[56] Thus, although ETFs and cryptocurrencies are among the most popular products at this time, they are not going to be brought together in the form of a cryptocurrency ETF taxed as a RIC.

As a result, investors have turned to other investment vehicles that do offer the ability to obtain pooled interests in cryptocurrency investments. Such pooled investment vehicles include the Grayscale Trust,[57] the Bitwise 10 Crypto Index Fund ("Bitwise Fund"),[58] and the Wise Origin Bitcoin Trust (the "Wise Origin Trust").[59] We will briefly look at each of them in turn.

The Grayscale Trust

The Grayscale Trust is structured for legal purposes as a statutory trust and is taxed as a grantor trust.[60] Units in the trust are publicly traded and provide the holder with a fractional undivided beneficial interest in the trust's holdings. The trust holds bitcoin, and its investment objective is to reflect the value of bitcoin based on the volume-weighted bitcoin price at various trading venues. As a grantor trust, the Grayscale Trust cannot vary its investments if it wants to maintain its flow-through tax status.[61] This means that the trust's investments are limited to its investment in bitcoin.

The Bitwise Fund

The Bitwise Fund is structured as a statutory trust but treated as a PTP for tax purposes.[62] Only accredited investors can invest in fractional undivided beneficial interests in the Bitwise Fund, with a minimum investment of $10,000. The Bitwise Fund holds a portfolio of cryptocurrencies that replicate an index of 10 cryptocurrencies that include bitcoin, ethereum, bitcoin cash, litecoin, and chainlink.

It is time for the Treasury or the IRS to issue definitive guidance as to whether some or all convertible cryptocurrencies are commodities as well as the tax status of nonconvertible virtual currencies. Until that happens, the taxation of cryptocurrency held in pooled investment vehicles remains uncertain.

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To avoid entity level taxation, the Bitwise Fund must meet the Qualifying Income Test, meaning that the cryptocurrencies it holds must be taxed as commodities. There is no definitive guidance on this issue, and therefore, the tax status of the income received by investors in the Bitwise Fund and the classification of the Bitwise Fund for federal tax purposes is uncertain.

Wise Origin Bitcoin Trust

The Wise Origin Bitcoin Trust filed a registration statement with the SEC on March 24, 2021, which is still pending at the date of this writing.[63] The registration statement states that the Wise Origin Trust intends to be treated as a grantor trust for tax purposes, with its investment objective to track the performance of bitcoin. Performance is measured by an index that tracks bitcoin price feeds from eligible spot markets and a volume-weighted median price.

Similar to the Grayscale Trust, the Wise Origin Trust, if approved, would be a grantor trust that cannot vary its investments.[64]

Conclusion

As we have tried to make clear, current tax rules prevent ETFs taxed as RICs from directly holding significant amounts of cryptocurrencies. This severely limits the choices available to small and retail investors desiring to hold interests in cryptocurrencies through pooled investment vehicles. It also raises serious questions about the taxation of those pooled investment vehicles that do hold cryptocurrencies. If "commodity" were clearly defined for tax purposes, this would significantly clarify the taxation of both direct cryptocurrency transactions, the income received from pooled investment vehicles holding cryptocurrency, and the nature of qualifying income for PTP purposes. This would also be helpful in providing clarity to retail investors as to what pooled investment vehicles are suitable for them.

It is time for the Treasury or the IRS to issue definitive guidance as to whether some or all convertible cryptocurrencies are commodities as well as the tax status of nonconvertible virtual currencies. Until that happens, the taxation of cryptocurrency held in pooled investment vehicles remains uncertain. There is a strong appetite for cryptocurrency-linked investment opportunities. The appetite of retail investors for cryptocurrency is evidenced, for example, by new products being offered on cryptocurrency exchanges and CFTC-regulated commodity exchanges. To meet investor demand, these exchanges are offering trading in smaller and smaller cryptocurrency units and derivatives.[65]

ENDNOTES

* They are the authors of the newly released fourth edition of FINANCIAL PRODUCTS: TAXATION, REGULATION, AND DESIGN (Wolters Kluwer, 4th ed. 2021).

1 *SEC v. Howey Co.*, 328 US 293 (1946).

2 Commodity Exchange Act, §1a(9).

3 Michael Mackenzie, *Realistic Investor Broaden Out Market Bets with ETFs*, FINANCIAL TIMES, May 8, 2021, at 16.

4 *Id.*

5 Robin Wigglesworth, *Global Passive Assets Hit $15tn as ETF Boom Heats Up*, FINANCIAL TIMES, May 10, 2021, at 8.

6 Phillip Stafford and Joe Rennison, *Rush for Speculative Assets Leaves Equities in the Shade*, FINANCIAL TIMES, May 7, 2021, at 10.

7 *See infra*, "How PTPs are Taxed."

8 SEC, *Exchange-Traded Funds: A Small Entity Compliance Guide*, modified December 6, 2019. This compliance guide addresses Rule 6c-11 and the exemptive relief from the Investment Company Act that it provides to ETFs.

9 Code Sec. 852(b)(6); *see also* SEC, *Investor Bulletin: Exchange-Traded Funds (ETFs)*, August 2012, at 5. All "Code Sec." references herein are to the Code, and all regulations (Reg. §; Temp. Reg. §; Prop. Reg. §) are to the final, temporary, or proposed regulations promulgated thereunder, unless otherwise indicated.

10 For a broader discussion of the tax issues associated with RICs, *see* Andrea S. Kramer and Nicholas C. Mowbray, *Regulated Investment Companies*, J. TAX'N FIN. PRODS., April 7, 2021.

11 Code Sec. 852. A RIC that satisfies certain distribution requirements may deduct the amount of dividends paid to its shareholders when computing its taxable income.

12 Code Sec. 851(a).

13 Code Sec. 851(b)(2). A qualified PTP is defined under Code Sec. 851(h) as a PTP other than a PTP that only earns certain types of qualifying income. The "qualifying income" test is discussed below and is indirectly relevant to the RIC rules discussed in this section. *See* Code Sec. 851(b)(2)(B).

14 Code Sec. 851(b)(3)(A).

15 Code Sec. 851(b)(3)(B).

16 Code Secs. 852(a)(1) and (2).

17 The government of El Salvador recently announced that it would adopt bitcoin as its legal tender. *See* Casey Wagner, *El Salvador to Become First Nation with Bitcoin as Legal Tender*, June 5, 2021, available at *https://blockworks.co/el-salvador-to-become-first-nation-with-bitcoin-as-legal-tender/*. While beyond the scope of this article, this raises the question of what it means to be a "currency" for U.S. federal income tax purposes and how this could affect bitcoin's tax treatment.

18 *See Simplify Equity Fund Prospectus*, available at *www.sec.gov/Archives/edgar/data/1810747/000182912621004242/simplifyexchange_497.htm*.

19 We discuss the Grayscale Trust later in this article.

20 *See Simplify Equity Fund Prospectus*.

21 *See* Volt ETF Form S-1, available at *www.sec.gov/Archives/edgar/data/1508033/000150803321000003/n1a0621.htm*.

22 Nicholas Pongratz, *Invesco Adds Bitcoin ETF Application to Growing List*, BE IN CRYPTO, June 10, 2021, available at *https://finance.yahoo.com/news/invesco-adds-bitcoin-etf-application-134214187.html*; *see also* Carla Mozee, *Bitcoin ETFs from Fidelity and Skybridge Capital Are Under Review by SEC*, BUSINESS INSIDER, May 27, 2021, available at *https://africa.businessinsider.com/markets/bitcoin-etfs-from-fidelity-and-skybridge-capital-are-under-review-by-the-sec/ds44e75*.

23 For a more in depth discussion of hedge funds, *see* Andrea S. Kramer and Nicholas C. Mowbray, FINANCIAL PRODUCTS: TAXATION, REGULATION, AND DESIGN, Wolters Kluwer (2021), Chapter 15; *see also* PWC, *3rd Annual 2021 Crypto Hedge Fund Report*, available at *www.pwc.com/gx/en/financial-services/pdf/3rd-annual-pwc-elwood-aima-crypto-hedge-fund-report-(may-2021).pdf*.

24 An accredited investor is someone who has financial sophistication. So the investor does not need the same protections as retail investors. An accredited investor is an individual that earns more than $200,000 per year (or $300,000 per year with a spouse or spousal equivalent), has a net worth of $1 million either alone or together with a spouse or spousal equivalent, or hold in good standing a Series 7, Series 65, or Series 82 professional certifications. Entities must have $5 million in liquid assets or all beneficial owners of the entity are accredited investors. *See* 17 CFR §§230.501.

25 Qualified purchasers must have at least $5 million in investments.

26 Likewise, the manager of a hedge fund may subject to CFTC jurisdiction as a commodity trading advisor.

27 Commodity pool operators may however qualify for reduced disclosure, reporting and recordkeeping requirements if they qualify for relief under 17 CFR §4.7.

28 17 CFR §4.7(a). The net worth and income requirements for individuals cross references the definition of an accredited investor under 17 CFR §230.501(a)(5).

29 This assumes that the fund itself is treated as a partnership for U.S. federal income tax purposes. Notwithstanding, it is not unheard

of for a U.S. taxable investor to invest through a non-U.S. entity, which could elect to be classified as a partnership or corporation for U.S. tax purposes. The reasons though for structuring an investment like this are beyond the scope of this article.

[30] Code Sec. 7704(b). *See also*, LTR Lexis 692 (1998).

[31] Code Secs. 7701(c) and 7704(a). For a discussion of the tax treatment of partnerships and PTPs, *see* Andrea S. Kramer and Nicholas C. Mowbray, Financial Products: Taxation, Regulation, and Design, Wolters Kluwer (2021), Chapter 47.

[32] Code Sec. 7704(d)(1).

[33] H.R. Rep. No. 100-495, at 496 (Dec. 21, 1987).

[34] *See* New York City Bar Association Committee on Taxation of Business Entities, *Report Requesting Guidance Concerning Various Provisions of Section 7704* (Jan. 10, 2011) (citing the definition of commodity under the Commodity Exchange Act).

[35] Notice 2014-21, IRB 2014-16, 938.

[36] For a discussion of the current tax rules that apply to cryptocurrencies, *see* Andrea S. Kramer, *The Confused State of Virtual Currency Taxation in 2020*, Taxes, October 2020, at 37–52. *See also* Andrea S. Kramer and Nicholas C. Mowbray, Financial Products: Taxation, Regulation, and Design, Wolters Kluwer (4th ed. 2021), Chapters 6 and 68.

[37] *See* Rev. Rul. 2004-78, 2004-2 CB 108 (stating that for purposes of Code Sec. 354, there is no definition of "security," and it is instead defined by case law).

[38] *See* Code Sec. 475(c)(2).

[39] Code Sec. 1236(c) (emphasis added).

[40] *D.E. Gantner*, 91 TC 713, Dec. 45,108 (1988), *later proceeding Gantner*, CA-8, 92 TC 192, Dec. 45,452 (1989) 90-2 ustc ¶50,335, 905 F2d 241, *cert. denied*, 498 US 921 (1990).

[41] *Id*.

[42] *Gantner*, 91 TC 721.

[43] *Id*.

[44] *Id*., at 724.

[45] Code Sec. 1091(a), *as amended* by P.L. 100-647, §5075(a), 102 Stat. 3342 (1988).

[46] §1a(9) (emphasis added). *See also Commodity Futures Trading Commission v. McDonnell et al.*, DC-NY, 287 FSupp3d 213, 228 (2018) (holding "[v]irtual currencies can be regulated by CFTC as a commodity.").

[47] CFTC Press Release, *CFTC Staff Issues Customer Advisory on Digital Tokens*, July 16, 2018.

[48] H.R. Rep. No. 100-495, at 496 (Dec. 21, 1987).

[49] Rev. Rul. 73-158, 1973-1 CB 337.

[50] LTR 8540033 (July 3, 1985).

[51] Reg. §1.6045-1(a)(5). There is an issue with respect to the phrase "approved by" the CFTC. This is because many futures contracts start trading under a self-certification procedure and some commentators question whether the "approved by" requirement is met. This self-certification discussion is beyond the scope of this article.

[52] Code Sec. 475(c)(2)(A).

[53] Code Sec. 475(e)(2).

[54] Reg. §1.1092(d)-1(c)(1).

[55] It appears likely that some virtual currency units and positions will be treated as commodities for tax purposes. *See* Reg. §1.6045-1(a)(5) (limiting the definition of commodity to property in which futures have been approved for trading by the CFTC). In addition to the question as to whether futures traded pursuant to the CFTC's self-certification process meet this definition, there is also a question as to whether futures contracts need to trade on a product at all for that product to be treated as a commodity for CFTC purposes. The way in which a commodity is defined for CFTC regulatory purposes is likely to serve as the guide for the tax definition for some Code provisions. As a result, those virtual currencies that are treated as commodities by the CFTC are, at a minimum, likely to be treated as commodities for tax purposes.

[56] As previously noted, El Salvador has converted its national currency to bitcoin. It is not clear as of the date of this writing as to the impact this may have on the classification of bitcoin, and possibly other cryptocurrencies, as a foreign currency for U.S. tax purposes.

[57] *See* Grayscale Trust Form S-1, available at *https://sec.report/Document/0001193125-17-013693/*.

[58] *See* Bitwise Fund 2020 Annual Report, available at *https://sec.report/otc/financial-report/261031*.

[59] *See* Wise Origin Trust Form S-1, available at *www.sec.gov/Archives/edgar/data/1852317/000119312521092598/d133565ds1.htm*.

[60] Grayscale's current suite of products that allow investors to have exposure to various cryptocurrencies include bitcoin, ethereum, bitcoin cash, ethereum classic, horizen, litecoin, stellar lumens, and Zcash. Grayscale has also recently registered a "long list of altcoins." *See Grayscale Registers Long List of Altcoin Trusts, Sparks Rumor of Support for Cardano, Polkadot, and Additional Assets,* The Daily Hold, January 30, 2021, available at *https://dailyhodl.com/2021/01/30/crypto-goliath-grayscale-registers-long-list-of-altcoin-trusts-sparking-rumors-of-support-for-cardano-polkadot-and-other-assets/*.

[61] *See generally* Reg. §301.7701-4. For a discussion of the tax treatment of grantor trusts, *see* Andrea S. Kramer and Nicholas C. Mowbray, Financial Products: Taxation, Regulation, and Design, Wolters Kluwer (4th ed. 2021), Chapter 48.

[62] On February 17, 2021, Bitwise Asset Management announced the launch of "the world's first DeFi (decentralized finance) crypto index fund." This fund is currently "available to accredited investors as a private placement and will reportedly seek approval to be publicly traded." Benzinga Staff, *Bitwise Asset Management Launches DeFi Crypto Index Fund*, Benzinga, February 18, 2021, available at *www.benzinga.com/markets/cryptocurrency/21/02/19740939/bitwise-asset-management-launches-defi-crypto-index-fund*.

[63] Available at *www.sec.gov/Archives/edgar/data/1852317/000119312521092598/d133565ds1.htm*; *see also Fidelity Launches Bitcoin ETF*, SWFI, March 24, 2021, available at *www.swfinstitute.org/news/85401/fidelity-launches-bitcoin-etf*.

[64] *See generally* Reg. §301.7701-4. For a discussion of the tax treatment of grantor trusts, *see* Andrea S. Kramer and Nicholas C. Mowbray, Financial Products: Taxation, Regulation, and Design, Wolters Kluwer (4th ed. 2021), Chapter 48.

[65] For example, bitcoin futures now trade in regular, mini, and micro contracts. The micro bitcoin future contracts that trade on the CME is 1/10th of one bitcoin and 1/50th of the standard bitcoin futures contract. Ledger X trades physically settled contracts on bitcoin, including a contract that has a size that is 1/100th of one bitcoin.

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