The Confused State of Virtual Currency Taxation in 2020

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Andrea S. Kramer examines some key tax principles and discusses how they may—or may not—apply with respect to virtual currency taxation.

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I. Introduction

The world of virtual currency (or cryptocurrency) is complex and murky. When it comes to the taxation of VC holdings and transactions, the situation becomes even murkier, making it particularly difficult for taxpayers and their advisors to be certain as to how to comply. In this article I look at some key tax principles and discuss how they may—or may not—apply with respect to VC taxation.

II. How Is VC Taxed?

Taxpayers have limited guidance from U.S. tax authorities about the taxation of VC coins, tokens, positions, and units (collectively, units). As a result, taxpayers with VC units find themselves in uncharted territory. At the date of publication, government advice is limited to Notice 2014-21,[1] Rev. Rul. 2019-24, and 2019 Frequently Asked Questions.[2] No precise Code sections or Treasury regulations specifically address VC.

A. The IRS's Positon that VC Is Property

In Notice 2014-21, the IRS said it views convertible VC as "property" for tax purposes, not as foreign currency. As a result, convertible VC is subject to the general tax rules that apply to property. The significance of designating VC as property is discussed in what follows.

B. VC Is Not Taxed as Foreign Currency

At the date of publication, VC is not accepted as the legal tender or "fiat" currency of any country. This means that VC is not any country's valid and legal tender.[3] Although VC has a digital representation of value and can be used as an alternative to money in some circumstances, it is not issued by a central bank, credit institution, or e-money institution.[4] Therefore, in Notice 2014-21, the IRS says that convertible VC is not foreign currency,[5] which means it does not qualify for the tax rules available to foreign currency transactions.

If at a future date a particular VC were to be issued by a country as its legal fiat currency or it became that country's legal currency, gains and losses on that VC would generally be taxed as foreign currency at ordinary rates, without regard to the taxpayer's tax status. Code Sec. 988 would apply without additional guidance from the Treasury or the IRS. Taxpayers should be aware of this possibility and monitor new developments.

There are four major consequences of VC not being taxed as foreign currency:

- First, the tax character (as capital or ordinary) of many foreign currency transactions does not turn on the taxpayer's tax status. Instead, many foreign currency transactions generate ordinary income or loss without regard to whether the taxpayer is an investor, trader, dealer, hedger, miner, staker, or personal user. Unlike foreign currency, ordinary income or loss is only available to VC users that hold VC as ordinary assets or that are eligible to make certain elections into ordinary tax treatment.[6]
- Second, each VC unit has its own tax basis, which requires taxpayers to track the basis of each unit they hold by identifying the individual units they dispose of. As discussed in Section III, below, taxpayers cannot rely on the average cost basis method for determining tax basis and calculating gains and losses as they can for foreign currency entered into for personal use (not business or investment purposes).[7]
- Third, individual taxpayers cannot rely on the personal use exemption that applies to foreign currency transactions. This means that taxpayers must report gain or loss every time they sell or spend VC units, with their gain or loss based on the change in their units' value between the time the units were acquired and when the units were disposed.
- Fourth, the $200 *de minimis* gain exclusion available to individual taxpayers for personal use foreign currency is not available to VC. As a result, all VC gains are taxable.[8]

C. When Is VC Taxed as a Security?

Some VC units are treated as securities for U.S. regulatory purposes by both the Securities and Exchange Commission (SEC) and the courts. This raises the question of whether the IRS might follow the SEC's lead and treat certain VC units as securities for tax purposes. Obviously, treating a VC position as a security could significantly affect its tax treatment. This section examines some representative places in the Code where securities are specifically addressed and considers possible application to VC.

The phrase "stock or securities" appears in various Code provisions. In some places it appears without a definition or explanation, while in other places it is defined for purposes of that specific Code provision. In all of the Code sections addressing stock or securities, however, stock is always defined as shares of stock in a corporation. As a result, VC is not stock for tax purposes.

But what about VC falling within the term securities? When "securities" is used in the Code, it typically refers 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, a securities dealer can hold securities in her investment account, and for that purpose securities are defined to include not just notes, bonds, debentures, and evidences of indebtedness, but also any evidence of an interest in or right to subscribe to or purchase any of those products.[9] Thus, a security dealer's investment account can include not just stock and debt securities but also options, warrants, and stock rights. Even under this expanded definition, however, it does not appear as if the term securities is broad enough to include VC units. And, as discussed in Section VII.A., securities are defined much broader in Code Sec. 475.

In considering how the term securities might be defined to apply to VC, it is particularly useful to consider the wash sales rule at Code Sec. 1091. The wash sales rule disallows certain losses from the sale or other disposition of stock or securities without providing any further elaboration of the phrase stock or securities. In *Gantner*,[10] the Tax Court held that stock options were not securities for wash sales purposes. In *Gantner* the taxpayer had purchased exchange-traded call options on stock, sold those options at a loss, and bought identical stock options within the 61-day prohibited time period for deducting wash sale losses. The IRS denied the taxpayer's deduction, asserting that the sale at a loss and the subsequent purchase were a wash sale.[11]

The *Gantner* Court disagreed with the IRS, finding that an option to acquire stock was not "stock or securities" and, therefore, did not fall within the plain meaning of the wash sales rule.[12] In reaching this conclusion, the Tax Court examined the 1920s legislative history to determine congressional intent when enacting the wash sales rule. The Tax Court said that Congress had never intended to treat stock options as securities subject to the wash sales rule, there having been no significant stock options market when the wash sales rule was enacted.[13] Moreover, Congress could have—but had not—amended the wash sales rule to include stock options in the securities definition once stock options started trading.[14]

In response to *Gantner*, Congress promptly amended the wash sales rule to expand its scope to include "contracts or options to acquire or sell stock or securities."[15] Interestingly, Congress did not attempt to define securities with this amendment, and it did not attempt to include options in the definition of securities. The fact that Congress felt it was necessary to amend the wash sales rule to include options is particularly instructive in considering whether a VC unit could be treated as a "security" for tax purposes.

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The key point to take away from this discussion is that VC was never considered by Congress when it enacted *any* of the Code provisions that apply to stock or securities. This strongly suggests that VC units are not likely to be treated as securities for tax purposes. It is possible, however, that the IRS might take a different view in some of the situations in which VC units—such as certain initial coin offerings (ICOs) and certain tokens—are treated as securities under SEC rules and court decisions.[16]

D. When Is VC Taxed as a Commodity?

Some VC units are treated by both the Commodity Futures Trading Commission (CFTC) and the courts as commodities for U.S. regulatory purposes. This raises the question of whether the IRS might follow the CFTC's lead and treat certain VCs as commodities for tax purposes. The answer to this question could significantly affect the way VC is taxed.

Because we do not have any Treasury or IRS guidance as to whether VC might be taxed as a commodity, this section addresses whether VC units might be commodities for tax purposes, and if so, how they would be taxed.

When considering whether property is a commodity for tax purposes, it is important to note that the IRS has "historically deferred" to the CFTC as to what constitutes a commodity.[17] The CFTC gets its regulatory authority from the Commodity Exchange Act (CEA), which defines a commodity quite broadly to include certain enumerated agricultural commodities, "all other goods and articles," and "all other services, rights, and interests … in which contracts for future delivery are presently or in the future dealt in."[18] Based on this broad definition, the CFTC has already asserted jurisdiction over certain—but not all—VC transactions.[19]

To consider when VC might be taxed as a commodity, we should also look at the Code provisions that refer to or define commodities. For example, the trading safe harbor that is provided for certain foreign investors in the U.S. commodity markets[20] defines commodities as being "of a kind customarily dealt in on an organized commodity exchange" where transactions in such items are "customarily consummated at such place."[21] In Rev. Rul. 73-158,[22] the IRS applied the trading safe harbor to off-exchange sales of raw sugar, ruling that the term commodities is used in its ordinary financial sense, including all actual commodities and commodity futures contracts that are traded and listed on U.S. commodity exchanges.

As discussed in Section VII.A., commodity is defined even more broadly in Code Sec. 475, which allows commodity dealers and traders to elect into the mark-to-market rule.

It seems clear, therefore, that some VC units are commodities for tax purposes.[23] Although, there is a question as to whether these include futures contracts on VCs that are traded pursuant to the CFTC's self-certification process, one way or another, it is safe to say that a VC that meets the CFTC's commodity definition is likely to be taxed as a commodity.

III. Tax Basis and Specific Identification

Taxpayers must record and track the tax basis of each unit of VC they hold to properly report taxable gain or loss when disposing of it. Taxpayers need to do this for each and every VC unit they hold in their wallet, account, or address.

In general, the tax basis of VC is the cost (expressed in U.S. dollars) paid to acquire the VC, including any commissions, fees, and acquisition costs.[24]

As property, the IRS reasons that each separate unit of convertible VC has its own tax basis.[25] The tax basis of VC received as payment for goods or services is treated as the fair market value of these goods or services as of the date of receipt.[26] Tax character of gain or loss from disposing of VC turns on whether the VC is an ordinary or capital asset in the taxpayer's hands.[27] The IRS treats purchases made with VC as barter exchanges, which means that both the person receiving the units and the person spending the units have taxable gain or loss.[28]

A. Importance of VC Tax Basis

Although tracking tax basis on a unit-by-unit basis might be burdensome in some situations, it provides taxpayers with the opportunity for significant tax benefits. Taxpayers can pick and choose which units they want to sell, selecting those units with the highest tax basis to *minimize* their current taxation, or, they can *maximize* current taxation by selling those units with the lowest tax basis.

Taxpayers who choose not to identify their units are subject to a default tax basis rule, meaning they will be taxed on the sale of their units on a first-in-first-out, or FIFO, basis.[29]

B. Average Cost Method Not Available for VC

Taxpayers holding multiple units of a given VC often acquire these units at different times and at different prices. If they sell a portion, but not all, of their units at any given time, they might want to use the average cost method to calculate gains and losses. The average cost

method is mandatory for partnership interests, foreign currency, and certain corporate transactions. It is elective for taxpayers who hold mutual fund shares. The average cost method allows, for example, electing taxpayers to calculate the value of their mutual fund positions on an aggregate basis to determine profit or loss. Such electing taxpayers can determine their tax basis by taking the average cost of all of the shares they own in a particular fund and multiplying the average cost by the number of fund shares they are selling. The average cost method can be a simple way to handle mutual fund sales for taxpayers who reinvest mutual fund dividends and regularly add to their mutual fund holdings.[30] There is no Treasury or IRS authority allowing taxpayers to use the average cost method for VC.

C. Application of Specific Identification to VC

According to the Notice and FAQs, taxpayers have two ways to identify the basis of specific VC units. Taxpayers can document a specific unit's unique digital identifier—such as a private key, public key, or address. Or, they can record all of the transaction information for their units in a single account, wallet, or address.[31]

For specific identification, taxpayers must record the following information:

- the date and time each unit was acquired;
- the basis and fair market value of each unit at the time acquired;
- the date and time each unit was sold, exchanged, or otherwise disposed of;
- the fair market value of each unit when disposed of; and
- the amount of money or the value of property received for each unit.[32]

By maintaining this information, taxpayers have complete flexibility in selecting the units they want to sell. In fact, taxpayers can replicate any of the possible basis tracking methods, changing their selection criteria as their tax objectives change.

IV. VC Losses Disallowed on Infrequent Activities

If a taxpayer's VC activities are too infrequent to rise to the level of investment activities and they do not otherwise qualify as trader or dealer activities, VC losses are not deductible. In these situations, the taxpayer's VC transactions are treated as personal transactions, a hobby, or as having been entered into for recreational use (collectively "personal use VC"). Personal use VC transactions include buying, selling, or otherwise disposing of personal use VC, using personal use VC to buy goods or services, and converting personal use VC into another VC or a fiat currency.

Because of 2017 tax law changes, losses from the sale of personal use VC are not tax deductible,[33] while gains are taxable as capital gains. This means personal use VC results in taxable gains and nondeductible losses. Also as a result of 2017 tax law changes, a taxpayer cannot deduct expenses attributable to personal use VC.

The taxpayer's standard capital gain rate applies to personal use VC. As intangible assets, VC units are not subject to the maximum capital gains tax rate applicable to tangible assets taxed as collectibles (such as coins or artwork).[34] Personal use VC transactions are reported on IRS Form 8949, Sales and Other Dispositions of Capital Assets.

All gains on personal use VC are taxable. Because VC is not treated as foreign currency, Code Sec. 988(e) does not apply so individuals cannot exclude up to $200 of gains from personal use VC transactions.

On an ongoing basis, taxpayers should evaluate their purpose in acquiring and holding VC to determine whether their activities remain taxable as personal activities. Given the tax differences between personal assets and other assets, taxpayers should keep accurate records to evaluate whether their activities have changed to warrant a different tax characterization as an investor, trader, or dealer.[35]

V. Application of Code Sec. 1256

Code Sec. 1256 requires taxpayers that hold Code Sec. 1256 contracts on the last business day of the year to report gains and losses as taxable even though they still hold their positions. Code Sec. 1256 applies to futures and options that qualify as Code Sec. 1256 contracts, which is potentially relevant to taxpayers buying, selling, and holding Bitcoin futures and options, Ether futures, and (perhaps) other VCs in the future.

Taxpayers are not generally taxed on VC gains until the positions are sold, exchanged, or otherwise disposed of unless those positions are Code Sec. 1256 contracts.

Two of the five types of Code Sec. 1256 contracts are potentially relevant to taxpayers buying, selling, and holding Bitcoin futures and options that currently trade on the CME. Whether Ether futures trading on ErisX also qualify as Code Sec. 1256 contracts depends on whether these contracts meet the statutory definitions at Code Sec. 1256(g).

A. Code Sec. 1256 Contracts Defined

Code Sec. 1256 contracts include regulated futures contracts (RFCs) and nonequity options.

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1. Regulated Futures Contracts

RFCs must meet two requirements. First, the amounts required to be deposited or allowed to be withdrawn on the contracts must follow a system of marking-to-market.[36] Second, the contracts must be traded on (or made subject to the rules of) a qualified board or exchange (QBE),[37] which includes a registered national securities exchange and a domestic board of trade (designated as a contract market by the CFTC). Bitcoin futures are subject to a system of daily marking-to-market, and the CME is a QBE. As a result, Bitcoin futures are RFCs. It is important to note that VC platforms are not likely to qualify as QBEs. This means that the first step is to determine whether a particular trading platform is a QBE. This analysis needs to be done for Ether futures.

2. Nonequity Options

Nonequity options follow a circular definition that involves the definitions of "listed options" and "equity options."[38] For these purposes, a listed option is defined as any option traded on or subject to the rules of a QBE,[39] and a nonequity option is any option on any item *other than* individual stocks or narrow-based stock indexes.[40] Working our way through this circular definition, nonequity options *can be* based on convertible VC but they must also be traded on a QBE. The CME's Bitcoin options meet this definition and qualify as nonequity options. Once again, this analysis needs to be done for Ether if options are available for trading. At the date of publication, other VCs and VC derivatives are not Code Sec. 1256 contracts.

B. Code Sec. 1256 Treatment

Code Sec. 1256 is not elective. Transactions that meet these definitions are subject to the mark-to-market rule and the 60/40 rule.[41]

1. The Mark-to-Market Rule

The mark-to-market rule provides that Code Sec. 1256 contracts that are open on the last day of the taxable year are marked-to-market; that is, they are treated as if they were sold on that date. All unrecognized gains and losses are taken into account *as if* the RFCs and options were sold for their fair market value on the last business day of the taxable year. Their fair market value is their settlement price.[42] All gains and losses are tallied up and used to compute taxable income.

When taxpayers terminate RFCs or nonequity options during the year (by offset or otherwise), these contracts are taxed at their sale or closeout price.[43]

Because taxes are paid on recognized and unrecognized gains and losses, taxpayers can be required to pay tax on gain that, in fact, they may never actually realize. (On the other hand, a taxpayer can report a mark-to-market loss on a Code Sec. 1256 contract that is never realized.) If they continue to hold contracts that were marked-to-market at year end, gains and losses realized in a subsequent tax year are adjusted to reflect gains and losses taken into account in the preceding taxable year.[44] The mark-to-market rule can, therefore, distort income and cause economic hardship if gains that were reported in the first year do not materialize in a subsequent tax year.

The mark-to-market rule applies to all Code Sec. 1256 contracts, without regard to whether they are ordinary or capital, unless the taxpayer is a hedger that has made a valid hedge identification.

2. The 60/40 Rule

Under the 60/40 rule, RFCs and nonequity options that are capital assets in a taxpayer's hands are taxed as 60% long-term and 40% short-term capital gain or loss. The 60/40 rule applies without regard to the length of time the taxpayer holds such positions, meaning that the capital gain holding period requirement is eliminated for Code Sec. 1256 contracts. RFCs and nonequity options that are ordinary assets in a taxpayer's hands are not eligible for 60/40 treatment.[45]

C. Straddles Consisting Only of Code Sec. 1256 Contracts

If a taxpayer holds tax straddles (that is, offsetting positions in actively traded property) that consist only of RFCs and nonequity options, such as Bitcoin futures and options, the Code Sec. 1092 straddle rules do not apply.[46] This is because the mark-to-market rule taxes all gains and losses on Code Sec. 1256 contracts as of the last business day of the year, preventing taxpayers from deferring their gains or accelerating their losses. For a discussion of the straddle rules, see Section VI.

D. Mixed Straddles

Taxpayers who hold RFCs or non-equity options might also hold actual VCs or other VC derivatives. If the taxpayers' positions meet the requirements of a straddle, they are subject to the straddle rules. Straddles that include both Code Sec. 1256 contracts and non-Code Sec. 1256 contracts are mixed straddles. For a discussion of mixed straddles, see Section VI.D.

E. Special Loss Carrybacks

Taxpayers who are not corporations, trusts, or estates can elect special loss carryback rules for Code Sec. 1256 contract losses that qualify for 60/40 treatment. Such

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taxpayers can use Code Sec. 1256 contract losses incurred in one year to reduce income on such contracts generated in prior tax years. This rule provides a form of income averaging not available to other taxpayers. Taxpayers can carry net Code Sec. 1256 contract losses back to each of the three preceding years and apply the losses against net Code Sec. 1256 contract gains recognized in those prior years.[47]

Losses that are carried back are treated as if they were 60% long-term and 40% short-term capital loss.[48] Carryback losses cannot be used to increase or produce a net operating loss for the prior taxable year.[49] Such losses are carried back to the earliest of the three preceding taxable years in which there is a net Code Sec. 1256 contract gain.[50] Any portion of the loss not absorbed in the earliest year can then be carried forward to the next taxable year and, if any loss remains, to the next (most recent) taxable year.[51] Any net Code Sec. 1256 contract loss carried forward from the first carryback year is again recharacterized as 60% long-term and 40% short-term capital loss.[52] The loss carryback election is quite complicated in its application, applying only after netting Code Sec. 1256 contract losses with unrelated capital gains and losses.

VI. VC Positions Subject to the Straddle Rules

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Taxpayers who hold VC positions may be subject to the straddle rules at Code Sec. 1092 and 263(g). The straddle rules could require taxpayers to defer losses on an offsetting position to the extent of unrecognized gain on other offsetting positions. Taxpayers who hold VC positions need to determine if the straddle rules will defer their losses and require them to capitalize certain otherwise deductible expenses. When taxpayers hold offsetting positions in actively traded personal property,[53] the straddle rules require them to defer their losses on closed positions while holding offsetting gain positions.

A straddle consists of holding two or more offsetting positions in personal property if one of the positions substantially diminishes the taxpayer's risk of loss from holding the other position. If one position protects the other position so there is a substantial diminution of risk of loss, this is enough to establish a straddle even if the amount of loss reduction is not reciprocal. Positions in actively traded personal property are of a type that are actively traded.[54]

An example might help put this into perspective. Let's assume a taxpayer holds 100 Bitcoins in her digital wallet. Assume for purposes of this example that Bitcoin is actively traded personal property (which is discussed below). Let's assume further that she agrees to sell 100 Bitcoins for delivery to a buyer in three months. This "short position" would be an offsetting position to her "long" Bitcoin position in her digital wallet. If she closes out her short position at a loss, the straddle rules prevent her from taking the loss on her tax return while holding an offsetting gain position.

The loss deferral rule requires taxpayers to defer losses on one or more offsetting positions to the extent of any unrecognized gain on other offsetting positions.[55] Temporary Treasury regulations include the modified wash sales rule and the modified short sale rule. The modified wash sales rule prevents a deduction for the disposition of a position at a loss if the taxpayer has an unrecognized gain in a successor position. The modified short sale rule suspends the holding period for a position during the period the taxpayer holds offsetting positions and positions that are successor positions to the initial offsetting position.[56]

The basic concept underlying the loss deferral rule is that taxpayers cannot deduct losses incurred with respect to a position in personal property if they also hold an offsetting position with an unrecognized gain.[57] If the loss deferral rule applies, a taxpayer must defer losses realized on any position in personal property that is part of the straddle while holding an offsetting position.[58] The straddle rules apply to VC positions that meet these requirements.

Under Code Sec. 263(g), taxpayers must also capitalize interest and carrying charges allocable to personal property that is part of a straddle. Interest and carrying charges include:

(1) interest expense incurred to purchase or carry property;
(2) expenses incurred to store, insure, or transport personal property; and
(3) amounts paid or incurred in connection with personal property used in a short sale.

A. Actively Traded Personal Property

Only actively traded personal property is subject to the straddle rules.[59] The Code does not provide any guidance as to when property is actively traded. And, the legislative history that accompanied enactment of Code Sec. 1092 only provides that to "be treated as actively traded, property need not be traded on an exchange or in a recognized market."[60] As a result, actively traded personal property includes more items than property that is traded on an exchange or in a recognized market.

Reg. §1.1092(d)-1(a) specifies that personal property is actively traded if there is an established market for that property, including:

(1) a national securities exchange;
(2) a commodity exchange registered with the CFTC; and
(3) an interdealer market.

An interdealer market is a market characterized by a "system of general circulation" (including quotations disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent transactions.

Given the rapid changes in the VC marketplace, taxpayers should carefully determine on a yearly basis whether there is an established market for the types of VCs they hold. Next, taxpayers should determine whether their VC units are actively traded and whether they hold offsetting positions.

B. Offsetting Positions

Losses realized on actively traded positions in personal property cannot be recognized to the extent that a taxpayer has unrecognized gains in an offsetting position.[61] This means that determining which positions offset other positions is critical to ascertain whether losses are currently deductible.

Taxpayers hold offsetting positions if their risk of loss from holding any personal property position is substantially diminished because they hold *one or more other positions* with respect to personal property. Neither the Code nor Treasury regulations define what is required for a position to substantially diminish the taxpayer's risk of loss. Relevant legislative history says that positions in the same personal property are offsetting if "the values of the positions vary inversely with each other. Generally, values vary inversely if the value of one position decreases when the value of another position increases."[62] Risk reduction because of mere asset diversification is not generally considered to substantially diminish risk.

C. Application to VC

Treating convertible VC as property for tax purposes means that general tax principles apply to convertible VC transactions.[63] A taxpayer who receives VC as the medium of exchange for the payment for goods or services is taxed at the fair market value of that VC, measured in U.S. dollars, as of the date the taxpayer received it.[64]

The straddle rules apply to VC that is actively traded if the taxpayer holds offsetting positions. Convertible VC, such as Bitcoin, has an equivalent value in an actual currency and it can act as a substitute for actual currency. Bitcoin can be traded online and can be purchased for, or exchanged into, U.S. dollars, other actual currencies, or other types of VC. It is likely, therefore, that there is an established trading market for Bitcoin. Nonconvertible VC, on the other hand, is not likely to qualify as actively traded personal property.

D. Mixed Straddles

Taxpayers often enter into offsetting long and short positions to minimize risk, defer tax, or convert short-term capital gain and long-term loss to maximize the possible benefits of tax-rate differentials. Particularly onerous tax consequences can result if taxpayers enter into offsetting positions where one—but not all—of the positions making up a straddle constitutes a Code Sec. 1256 contract while another offsetting position is not a Code Sec. 1256 contract.

Taxpayers who hold offsetting Bitcoin positions need to consider the additional tax implications of possibly holding mixed straddles. For a discussion of the mixed straddle rules, see Section VI.D.

1. In General

VC positions are subject to the straddle rules if the VC is actively traded personal property *and* the taxpayer holds offsetting positions.[65]

By way of example, because Bitcoin has an equivalent value in actual currency; can be substituted for actual currency; is traded on established markets; and can be purchased for or exchanged into U.S. dollars, other actual currencies, or other VCs, it is likely that Bitcoin is subject to the straddle rules.

This means that taxpayers who enter into offsetting positions where one or more—but not all—of the positions making up a straddle are Code Sec. 1256 contracts hold mixed straddles. Adverse consequences can be magnified or made more complex by application of these special rules.

Taxpayers who enter into certain VC transactions can hold mixed straddles and need to consider ways to minimize or avoid adverse consequences.

Taxpayers who do nothing—whether intentionally or inadvertently—are subject to the "killer rule," which applies to convert a short-term loss from a non-Code Sec. 1256 position to a 60/40 loss.[66] Short-term gains offset by 60/40 losses are left unchanged. The killer rule converts only one way—in the government's favor—and it is a killer to any taxpayer with a substantial volume of mixed straddles. This one-way conversion typically has a punitive tax effect, which can be avoided by making the elections and identifications discussed below.

2. Why Special Rules Are Needed

In the absence of the mixed straddle rules, taxpayers could generate short-term loss in a non-Code Sec. 1256 contract

position and an offsetting 60/40 gain in a Code Sec. 1256 contract. The short-term loss could then be used to mop up unrelated short-term gain (leaving the taxpayer with only long-term capital gain). The mixed straddle rules prevent taxpayers from doing this. They also prevent taxpayers from reporting 60/40 gain or loss on Code Sec. 1256 contracts and (depending on the taxpayer's holding period) 100% short-term or long-term capital gain or loss on their non-Code Sec. 1256 positions.[67]

3. Taxpayer Choices

Taxpayers can avoid the killer rule by selecting one of the four mixed straddle choices set out in what follows; doing nothing is never a recommended way to proceed:

- **Elect Out of Code Sec. 1256.** A taxpayer can make a one-time Code Sec. 1256(d) identified mixed straddle election to remove Code Sec. 1256 contracts from Code Sec. 1256 treatment. The mixed straddle remains subject to the straddle rules. Interest and carrying charges incurred to carry the mixed straddle position must also be capitalized.
- **Make an "Identified Straddle Identification."** If a taxpayer's mixed straddle qualifies as an identified straddle under Code Sec. 1092(a)(2), the taxpayer can designate the straddle as an identified straddle. Instead of deferring straddle losses, the taxpayer must adjust the tax basis on the gain position to reflect nondeductible straddle losses.[68] Interest and carrying charges incurred to carry the mixed straddle must also be capitalized.
- **Straddle-by-Straddle Identification.** A taxpayer can identify a mixed straddle using straddle-by-straddle identification under Code Sec. 1092(b)(2). The taxpayer nets all gains and losses on the mixed straddle. In addition, the taxpayer must defer recognition of pre-straddle gain or loss on any positions that had been open before the straddle was entered into[69] under Reg. §1.1092-6T.[70] The straddle rules still apply after the taxpayer makes the required computations.[71]
- **Establish a Mixed Straddle Account.** A taxpayer with a large number of mixed straddles can establish a mixed straddle account for each class of activities, with gains and losses recognized and offset on a periodic basis. The taxpayer must carefully determine which positions qualify as a class of activities. It is not likely, for example, that a Bitcoin mixed straddle account could properly include other types of VCs. The convenience of a mixed straddle account is offset by a tax cost. Not more than 50% of any net gain derived from positions in the account (whether or not otherwise qualified for Code Sec. 1256 treatment) can be treated as long-term capital gain, while not more than 40% of any net loss can be treated as short-term capital loss.[72]

VII. Electing into Code Sec. 475

VC traders seeking to deduct trading losses and avoid application of capital loss limitations might want to elect into the special rules at Code Sec. 475. Such taxpayers must analyze the definitions of "securities" and "commodities" to determine whether they are eligible for either of the Code Sec. 475 trader elections and to consider the federal and state tax implications of making such an election. Taxpayers who qualify for and elect into either of these elections would mark their VC gains and losses to market.

Electing into Code Sec. 475 means taxpayers receive ordinary income and loss on positions closed out during the year and on all positions open at the end of the year. In exchange for ordinary treatment and for accelerating tax on open positions, electing traders can report losses without applying capital loss limitations, the wash sales rule, or the straddle rules.

The trader elections depend on two requirements. First, the taxpayer's VC transactions must qualify for tax purposes as "securities" for the securities trader election[73] or as "commodities" for the commodities trader election.[74] Second, the taxpayer's activities must rise to the level of active trading under applicable case law.

This section addresses the analysis that taxpayers who hold VC positions need to make to evaluate whether they are eligible for the Code Sec. 475(f) election as either a trader in securities or as a trader in commodities (collectively, the trader elections).

A. Securities or Commodities Positions

To make a valid trader election, taxpayers must determine if their VC positions qualify as securities or commodities as those terms are defined in Code Sec. 475. These definitions are broader than the general definitions of securities and commodities discussed in Sections II.C. and II.D.

1. Securities Defined

Code Sec. 475 broadly defines a security to include *any*:

(1) share of stock;
(2) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust;
(3) debt interest;[75]
(4) interest rate, currency, or equity "notional principal contracts" (such as swaps, caps, and floors);
(5) any evidence of any interest in, or any derivative financial instrument in, any currency or security within the terms of items (1) through (4), including

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options, forwards, short positions and similar financial instruments; and

(6) a position that is not itself a security under items (1) through (5), above, but the position is a "hedge" of such a position and it is clearly identified as a hedge with respect to that security.[76] There is no requirement that the item, itself, must be actively traded. (Although the term "security" does not include Code Sec. 1256 contracts, such contracts can be treated as securities if they qualify as hedges under this item (6).

Because the positions that qualify as securities are carefully enumerated in Code Sec. 475(c)(2), it is not likely that the IRS will try to treat other items as securities for purposes of Code Sec. 475 just because they are securities for federal securities law purposes. It is likely that the IRS will only treat items as securities if the items clearly fit into the enumerated items. This means that taxpayers who enter into VC positions need to carefully consider item (5) or (6) above to see whether their positions might meet the definition of that item.

2. Commodities Defined

The term commodity is broadly defined in Code Sec. 475 to include any commodity that is *actively traded* for purposes of the straddle rules at Code Sec. 1092(d)(1),[77] which requires an established financial market, ranging from an interdealer market to an established financial market. Commodities include physical commodities, derivative instruments in any commodity, and evidences of interests in any commodity. Unlike the Code Sec. 475 statutorily enumerated definitions of a "security," which specifically *excludes* Code Sec. 1256 contracts, the term "commodity" specifically *includes* Code Sec. 1256 contracts, making them subject to Code Sec. 475 rather than Code Sec. 1256. As with the definition of security, the commodity definition includes any position that is not itself a commodity *if* it is a hedge with respect to a commodity.

Although not free from doubt, the IRS has deferred to the CFTC in the past as to what constitutes a commodity. As discussed in Section II.D., the term "commodities" is used in Code Sec. 864(b)(2)(B) in its ordinary financial sense and includes all products that are traded and listed on U.S. commodity exchanges. This makes it possible that Code Sec. 475 will include actively traded items that are commodities under the federal commodity laws.

3. Are VCs Securities, Commodities, or Neither?

Most VCs that meet one of the two required definitions are more likely to qualify as commodities than securities. With that said, there is no definitive answer one way or the other as to whether certain VC positions can be treated as securities or commodities. There are good arguments that *certain* VC positions are securities and that *other* actively traded VC positions are commodities. But, there are also good arguments that most VC positions are neither.

B. Taxpayers Must be Active Traders for Code Sec. 475

If a particular VC qualifies as a security or a commodity, electing taxpayers must also meet another requirement: their activities must be substantial and carried on in a continuous and regular basis. Trader tax status is fact-based, subject to the taxpayer's actual facts and circumstances.

The trader election is effective only if the electing taxpayer is a trader,[78] where her income is not based on any service she provides but rather on fluctuations in the market value of the securities or commodities she holds.

Traders must profit from daily market movements, not from dividends, interest, or capital appreciation. IRS Publication 550 identifies some factors to consider, including the length of holding periods, frequency of trades, whether the taxpayer is engaged in the activity to produce a principal source of income, and the amount of time the taxpayer devotes to the trading activity.[79] The phrase "trade or business" is not defined in the Code or Treasury regulations, although various factors are considered, with no one factor dispositive. Elements of a trade or business include:

(1) activities that occupy "the time, attention and labor" of the taxpayer for the purpose of "a livelihood or profit";
(2) the continuity and regularity of the taxpayer's activities; and
(3) a profit motive.

In *Groetzinger*, for example, the Supreme Court held that a professional gambler could be in a trade or business if he devotes his full-time activity to gambling, and it is his intended livelihood source. In this situation, the gambler's activity is a trade or business, "just as any other readily accepted activity."[80]

C. Trade or Business Expenses

Trade or business expenses are deductible under Code Sec. 162. Deductible expenses can include office rental, other office expenses, salaries, computer equipment, software programs, Internet access fees, and utilities.

D. Application of Trader Elections

Electing traders receive ordinary income or loss for their securities and commodities positions that are held *in*

connection with their business of being securities or commodities traders. Because taxes are paid on recognized and unrecognized gains and losses, electing traders can be required to pay tax on gains that, in fact, they may never actually realize. If they continue to hold contracts that were marked-to-market at year end, gains and losses realized in a subsequent tax year are adjusted to reflect gains and losses taken into account in the preceding taxable year. The requirement to mark open positions to market can, therefore, distort income and cause economic hardship if gains that were reported in the first year do not materialize in a subsequent tax year.

In evaluating the costs of accelerating gains under the mark-to-market regime, electing traders must also evaluate the fact they can deduct their trading losses against trading profits and ordinary income from other sources. Losses of electing traders are not limited to the standard $3,000 capital losses amount.

E. Elections and Revocations

Elections into Code Sec. 475 and revocations of such elections are subject to detailed reporting and filing requirements. Late elections or revocations are not generally allowed except in unusual and compelling circumstances that comply with Treasury regulations and IRS guidance.

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VIII. VC Mining

VCs are created and transferred based on blockchains (digital ledgers) that, given the absence of a trusted third party, require some type of an algorithm to achieve consensus among participants (distributed consensus) as to the validity of transactions (blocks). This validation process is designed to ensure that the next block of transactions added to the blockchain represents the most current transaction, eliminating the possibility of double-spending units.

Two popular types of distributed consensus methodologies are proof of work (PoW) and proof of stake (PoS). PoW relies on "miners" who conduct mining activities by solving complex mathematical calculations. VCs such as Bitcoin rely on PoW. PoS is a consensus validation mechanism where "stakers" validate VC being confirmed on the blockchain.[81] VCs such as Tezos rely on a PoS blockchain. Both PoW and PoS are subject to the terms of the respective protocol in place for the particular VC transactions being verified or confirmed. (There are wide variations between PoW and PoS blockchains, as well as hybrids of both.)

This section discusses the tax issues—as of the date of publication—of income and expenses associated with PoW mining activities. PoS activities are discussed in Section IX.

A. VC Mining Activities

Miners confirm VC transactions by sophisticated and high-powered computer processes to solve complex mathematical problems. When a miner validates the addition of a new block (group of transactions), that participant (node) is paid for its services in pre-specified units of a pre-specified VC.

There are no Code sections, Treasury regulations, or judicial decisions addressing VC mining. The only government guidance is Notice 2014-12,[82] where the IRS set out its preliminary views on the taxation of Bitcoin mining.

Notices do not have the force of law, and courts do not need to follow IRS pronouncements, including Notices. Therefore, although a Notice sets out the IRS's interpretation of tax law, it does not have precedential value. The force of an IRS Notice is only as strong as the legal authorities the IRS cites in the Notice and the persuasiveness of the IRS's application of the tax laws to the particular facts in a given transaction.[83]

PoW miners of VCs other than Bitcoin should determine if the mining processes for those VCs are sufficiently similar to that for Bitcoin so that those miners are justified in applying the IRS's analysis to their units.

B. All Miners Earn Income

The IRS's position is that by performing the PoW validation service, the fees the miners receive in VC units are ordinary income, taxable at the fair market value *as of the* date they receive the units. The IRS asserts that miners cannot wait to include the value of the units they receive in income until they subsequently purchase goods or services or otherwise convert these units into U.S. dollars or another fiat currency. According to the Notice, all Bitcoin miners—even small-scale miners that receive minimal fee income—must report their fees as ordinary income when received.

Given the fact that a Notice is simply the IRS's litigating position, some miners take a contrary tax position, treating the units they receive from mining as not being taxable upon receipt but only when sold, exchanged, or otherwise disposed of. Such taxpayers argue that the units they receive from mining are more like certain forms of mineral extraction where taxpayers do not pay tax on extracted minerals until they actually dispose of the minerals.[84]

C. Miners in a Trade or Business

To have deductible business expenses, miners need to be traders (who seek profits based on market fluctuations,

not from passively overseeing their VC investments) or dealers (who are in the business of buying and/or selling VC to customers in the ordinary course of business). Whether a miner's activities rise to the trader level often boils down to two things: the volume of its transactions and the ability to establish that these activities constitute an active trade or business.[85] For a discussion of the phrase "trade or business," see §VII.B., above.

Whether miners are dealers turns on if they have customers in the ordinary course of their trade or business.

If mining activities rise to the level of a trade or business, miners can deduct appropriate business expenses and losses against their ordinary income.[86] Deductible mining expenses can include office rental, other office expenses, computer equipment, software programs, Internet access fees, electricity, and other utilities. In fact, some computer equipment might be eligible for depreciation deductions.

Miners who are employees receive wages from their employers. Miners who work for themselves have net earnings from self-employment, which is treated as self-employment income and is subject to self-employment tax.[87] Self-employment income and expenses are reported on Schedule C.

D. Miners Not in a Trade or Business

Not all mining activities qualify as a trade or business. Miners can engage in mining for their personal use or as a hobby.[88] Although such miners would receive income for successful mining activities, they would not be able to deduct losses or business expenses. Limited itemized deductions might be available for some expenses if the miners were viewed as investors, but investors are not allowed to deduct business expenses against income.[89]

E. Selling, Exchanging, or Disposing of Mined VC

Whether miners treat the units they receive from successful mining as taxable when they receive them or only when they sell them, all miners have a taxable event when they sell, exchange, or dispose of the VC they receive from mining operations.

As with all taxpayers, miners should carefully document their mining activities and related expenses to support their federal and state tax positions. The IRS has the authority to deny deductions if taxpayers do not properly document their expenses.[90]

F. Pools and Entities

Miners often join together with others in pools or business relationships that are subject to a wide variety of financial arrangements. Miners who work with others need to consider whether they will be treated as being in a partnership or taxable association. If mining pools are deemed to be an entity, they are subject to the federal and state tax rules and tax reporting requirements that apply to such arrangements.

IX. VC Staking Activities

Stakers—taxpayers involved in PoS validation of blockchain transactions—are operating in totally uncharted tax waters. The Treasury and the IRS have provided no guidance as to when or whether staking rewards are included in taxable income. This means that taxpayers must adopt a tax methodology that they believe is supportable on audit, subject of course to judicial review. This section discusses federal tax issues—as of the date of publication—of income and expenses associated with PoS staking activities.

A. VC Staking

In PoS systems, stakers are chosen by combinations of random selection and the amount of units they have staked and/or the amount of time they have agreed to lock up the stakes in a specific digital wallet. Staked units support the blockchain operations. Unlike the mining activities of PoW blockchain miners, stakers validate new blocks by forging on the next block without mathematical computations. PoS protocols require stakers to hold and stake a minimum number of units to participate in the validation process. As staking rewards, stakers receive a specified number of units generally taken from other participants as transaction fees. These reward units redistribute VC ownership away *from* computers (nodes) that do not put up a stake *to* those nodes that put up stakes.

B. When Are Staking Rewards Includable in Taxable Income?

Before turning to the issues of when staking rewards are included in taxable income, it is useful to consider what the IRS has said about mining fees in PoW blockchains. As is discussed in §VIII., above, Notice 2014-21[91] sets out the IRS's position that miners receive taxable income when they receive mining fees. The Notice says that miner's fees are taxable at their fair market value as ordinary income *as of the* date they receive the units. The IRS also asserts that miners cannot wait to include the value of these units in income until they subsequently purchase goods or services or otherwise convert these units into U.S. dollars or another currency. According to the Notice, all Bitcoin miners must report their mining fees as ordinary income when they receive them.

Because the Notice does not address staking and there is no other governmental guidance, stakers take a wide

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range of tax positions with respect to their staking rewards. Some taxpayers take the position that staking rewards are sufficiently similar to payments received by successful VC miners so that staking rewards should be taxed under the Notice upon receipt.

Other taxpayers assert that their staking rewards are not taxable until they sell, exchange, or otherwise dispose of the rewards. Some of these taxpayers argue that staking rewards are more like the extraction of actual minerals where some taxpayers do not pay tax until they subsequently dispose of the extracted minerals.[92] Taxpayers seeking to rely on the tax treatment of oil and gas transactions, however, need to be aware that oil and gas transactions are quite specialized, "primarily because many of the basic concepts were the result of liberal administrative interpretations of various sections of the Code by the Treasury during a period when congressional policy was to encourage the development and production of oil and gas properties."[93] Obviously, there is no assurance that similarly favorable policies and interpretations will ultimately be applied to VC.

Other taxpayers take the position that their staking rewards are not taxable at receipt because their staking activities are similar to harvesting of agricultural products or the offspring of livestock. They argue that staking rewards should not be taxable until they are actually disposed of by the taxpayer.

Other taxpayers assert that staking rewards are not taxable under Code Sec. 61 because their rewards (or at least some portion of the rewards) do not meet the definition of income, while still other taxpayers assert that staking rewards do not represent an "undeniable accession to wealth" that is "clearly realized" and to which the taxpayer "has complete dominion."[94]

There is no direct authority with respect to any of these tax positions, so taxpayers must proceed with caution.

C. Are Stakers in a Trade or Business?

To deduct business expenses related to staking operations, stakers need to be traders (who seek profits based on market fluctuations, not from passively overseeing their VC investments) or dealers (who enter into VC transactions with their customers in the ordinary course of their business). Whether a staker's activities rise to the level of a trade or business boils down to two things: the volume of their transactions and their ability to establish that these activities constitute an active trade or business.[95]

Stakers who delegate their tokens to others to stake are not likely to have activities that would rise to the level of a trade or business without more activities.

If staking activities rise to the level of a trade or business, stakers can deduct appropriate trade or business expenses.[96] Deductible staking expenses include, for example, office rental and other office expenses, salaries, computer equipment, software programs, Internet access fees, electricity, and other utilities. Deductible business expenses and depreciation reduce taxable income.

Those stakers who engage in staking activities for investment or as a hobby are not in a trade or business. As a result, they do not have deductible business expenses. Limited itemized deductions might be available for some investment expenses, but such stakers do not have business expenses deductible against income.[97]

As with all taxpayers, stakers should carefully document their staking activities, staking rewards, and related expenses to support their federal and state tax positions. Because stakers are in totally unchartered tax waters, they need to work closely with their tax advisors.

D. Selling, Exchanging, or Disposing of Staking Rewards

Without regard to whether stakers treat their rewards as taxable upon receipt or only when they sell their rewards, all stakers have a taxable event when they dispose of the units received from successful staking operations.

E. Pools and Entities

Stakers often join together with others to pool their units to increase their stake and to increase the likelihood that they will successfully validate blocks and receive rewards. These business relationships are subject to a wide range of financial relationships. Stakers who join with others, therefore, need to consider whether they will be treated as being in a partnership or taxable association, and they need to consider the federal and state tax implications of their entity selection. Stakers deemed to be in an entity are subject to the federal and state tax rules and tax reporting requirements that apply to such an arrangement.

X. Crypto Loans

Transactions involving the borrowing and lending of VC units (referred to as crypto loans) are increasing in number and type. Lacking Treasury and IRS guidance, potential tax issues with respect to crypto loans must be analyzed in accordance with broad, general tax principles established by case law and based on government guidance developed in other tax areas.

Although there are many questions about the tax treatment of crypto loans, this section addresses one basic question: Are the transfers of VC at the beginning and at the end of a crypto loan taxable at the time of the transfers, or are only the fees or interest paid and received in

connection with the transaction taxable? The answer to this question is by no means free from doubt. To address this question, this section discusses the tax issues posed by two common types of crypto loans and makes some suggestions for supporting the taxation of these transactions as loans, not sales or exchanges of property.

A. What Is a Loan for Tax Purposes?

Let's start with the question of what is a loan for tax purposes. A loan is an indebtedness that is an existing, unconditional, and legally enforceable obligation for one party (borrower) to pay a sum certain of money on demand or on a specified date to the other party (lender).[98]

For example, the borrower might borrow money from the lender, pay interest for the use of that money, and agree to repay the money at a future date. Entering into such a loan is not taxable to either the borrower or the lender, nor is the repayment of the principal amount of the loan taxable. The receipt or accrual of interest on the loan is, however, taxable as "compensation for the use or forbearance of money."[99] Although interest is not defined in the Code, it is generally viewed as a payment in return for the use of money or other property and is taxable as ordinary income[100] to the lender. The Supreme Court has described interest as the "amount which one has contracted to pay for the use of borrowed money."[101] The borrower's payment of interest is not, however, deductible if the loan is for the borrower's personal use and may be subject to certain limitations if it is for investment or business purposes.

The major difficulty in treating crypto loans as loans for tax purposes is Notice 2014-21, which states that (at least as far as the IRS is concerned) convertible VC is property,[102] and according to established case law, a loan for tax purposes is "a debt [that] necessarily involves an obligation to pay money and not an obligation to deliver property."[103]

B. What Happens If a Crypto Loan Is Not Taxed as a Loan?

In general, a transfer of money in exchange for property is treated as a taxable sale or exchange of property. As such, there is an immediate recognition of gain or loss on the exchange. Gain from a sale equals the excess of the amount realized over the seller's adjusted basis. Loss from a sale equals the excess of the seller's adjusted basis over the amount realized.[104]

If a crypto loan is deemed to be a sale or exchange of property and not a loan, the transaction would be broken into two separate transactions: the initial transfer of the VC at the opening of the "loan" and the return of the VC when closing the "loan."

C. Two Common Types of Crypto Loans

The first type of crypto loan—here called a "crypto borrow transaction"—involves one party (the borrower) borrowing VC from another party (the lender) with the borrower posting collateral (cash, another type of VC, or other agreed-upon property). The borrower agrees to return to the lender an identical amount of the same VC at the end of the agreement and the lender agrees to return the collateral. Crypto borrow transactions are typically structured to resemble securities lending transactions that are subject to a specific Code provision that prevents gain or loss on the transfer of securities.[105] The borrower is free to sell or otherwise dispose of the VC subject to the loan, and the lender is often allowed to sell or otherwise dispose of the collateral. If during the term of the agreement there is an airdrop or hardfork with respect to the particular VC that was borrowed, the borrower transfers back to the lender units of VC identical to those that were received in the airdrop or hardfork (not money or other property). In many crypto borrow transactions, the borrower or lender (or both) can terminate the agreement on demand, or on a specified number of days' notice.

In the second type of crypto loan—here called a "crypto collateral transaction"—a lender loans the borrower fiat currency (such as U.S. dollars) and the borrower posts VC (such as Bitcoin, Ether, or another highly liquid VC) with the lender as collateral. A principal objective of crypto collateral transactions is for the borrower to monetize a VC position without triggering a taxable sale. These transactions are relatively straightforward. When the loan matures, the borrower re-pays the lender the dollar amount of the loan plus interest, taking back identical VC to that which the borrower had posted as collateral. If during the term of the loan there is an airdrop or hardfork, the lender must transfer VC units to the borrower identical to what is received in the airdrop or hardfork (not money or other property). In a crypto collateral transaction, there is often a fixed term, but the borrower can repay the U.S. dollar loan prior to maturity.

D. Considerations to Bolster Arguments That a Crypto Loan Is a Loan

Because of the importance that the tax law places on the substance of a transaction rather than its form, taxpayers must carefully examine the terms of each crypto loan to determine whether the transaction is more likely to be taxed as a sale or exchange of property or as a loan. Some of the key tax factors to consider when addressing the proper taxation of particular crypto loan transactions follow:

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- Consider the benefits and burdens of tax ownership as a result of the transaction. If ownership of the VC is deemed transferred at the opening of the crypto loan, taxation of the transaction as a sale or exchange is clearly established. The issue, therefore, is whether ownership has transferred.
- The following factors, as set out by the Tax Court in *Grodt & McKay Realty, Inc.*,[106] are typically considered in evaluating tax ownership:
  (1) whether legal title passes;
  (2) how the parties treat the transaction;
  (3) whether an equity interest is acquired in the property;
  (4) whether the contract imposes a present obligation on the lender to execute and deliver a deed and a present obligation on the borrower to make payments;
  (5) whether the right of possession is vested in the borrower;
  (6) which party pays the property taxes;
  (7) which party bears the risk of loss or damage to the property; and
  (8) which party receives the profits from the operation and sale of the property.

In evaluating these factors, the courts do not generally regard any one factor as determinative, recognizing that not all factors are relevant in any given case.[107] The important point, however, is that the more factors that point to the holder of the VC as being the "owner" of the VC after executing the transaction, the more the transaction looks like a sale, not a loan:

- If the crypto loan is fully recourse, this points toward the transaction being viewed as a loan.
- The crypto loan should be structured and documented as a traditional loan transaction, and the parties should adhere to normal loan practices.
- The parties should treat the transaction as a loan in their records and on their tax returns.
- The repayment should be made in VC units that are identical in type and denomination to the VC that is transferred at the start of the transaction. The same rules should apply to any airdrops or hardforks that happen during the terms of the transaction.

E. Possible Approaches to Avoid a Crypto Loan Being Taxed as a Sale or Exchange of Property

The possibilities to avoid a crypto loan being taxed as a sale or exchange of property include the following:

- The borrower did not receive back property from the crypto loan that was materially different either in kind or extent and, therefore, there should be no tax recognition under Reg. §1.1001-1(a).
- The transaction qualifies as a securities loan eligible for tax free treatment under Code Sec. 1058.
- The transaction qualifies as a loan under the general tax authority addressing repurchase agreements and reverse repurchase agreements.
- The transaction is structured as a bailment transaction so that the bailor deposits fungible VC with the bailee and the VC is comingled with the goods of the bailee, so that when different but identical VC is returned to the bailee, the return is not treated as a taxable sale.[108]

Taxpayers should carefully consider the tax factors that support treating their crypto loans as loans. They should carefully consider their transaction documents, keep detailed and accurate records of their transactions, and discuss their transactions with their tax advisors to determine appropriate tax reporting.

Crypto exchanges, wallet providers, and custodians must also consider these issues as they determine appropriate Form 1099 reporting obligations with respect to Forms 1099-B, 1099-MISC, or 1099-INT. Such entities must also consider withholding taxes for foreign persons because gain is not treated as fixed, determinable, annual, or periodic income.[109]

XI. Conclusion

As should be clear, there are many open questions with respect to VC taxation. As with all tax issues, taxpayers need to work closely with their tax advisors to properly document their transactions and to prepare their federal and state tax returns. Reporting obligations carry significant penalties, and state tax treatment in many states does not follow federal tax rules.

ENDNOTES

* Andrea S. Kramer is the author of *Financial Products: Taxation, Regulation, and Design* (Wolters Kluwer, 3rd edition, 2006) and co-author (with Nicholas Mowbray) of the fourth edition that will be released in late 2020. Prior versions of parts of this article were previously released as *On the Subject Bulletins* by McDermott Will & Emery LLP. The views in this article are those of the author, not necessarily those of McDermott. This article is for general information purposes only and should not be construed as legal advice or any other advice on any specific facts or circumstances. No one should act or refrain from acting based upon any information herein without seeking professional legal advice. McDermott and Andie make no warranties, representations, or claims of any kind concerning the content herein. McDermott and Andie expressly disclaim all liability to any person in respect of the consequences of anything done or not done in reliance upon the use of contents included herein. This material may be considered attorney advertising. Prior results do not guarantee a similar outcome.

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21 Code Sec. 864(b)(2)(B)(iii).
22 Rev. Rul. 73-158, 1973-1 CB 337.
23 *Compare* Reg. §1.6045-1(a)(5) (limiting the definition of commodity to property in which futures have been "approved" for trading by the CFTC).
24 Code Sec. 1012(a).
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34 *Id*.
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39 Code Sec. 1256(g)(5)
40 Code Sec. 1256(g)(6)(A).
41 Code Sec. 1256 treatment does not apply to qualified hedging transactions, identified Code Sec. 1256(d) mixed straddles (where mixed straddle election has been made), or mixed straddle accounts.
42 Code Sec. 1256(c)(3).
43 Code Sec. 1256(c)(1).
44 Code Sec. 1256(a)(2).
45 Code Secs. 1256(a)(3), 1256(f)(2).
46 Code Secs. 1092(d)(5)(A), 1256(a)(4).
47 Code Sec. 1212(c).
48 Code Sec. 1212(c)(1).
49 Code Sec. 1212(c)(3).
50 Code Sec. 1212(c)(2).
51 Code Sec. 1212(c)(2).
52 Code Sec. 1212(c)(6)(A).
53 Code Sec. 1092(a)(1); Regs. §§1.1092(b)-1T and -2T.
54 Code Sec. 1092(d)(1).
55 Code Sec. 1092(a)(1)(B).
56 Temporary Reg. §1.1092(b)-2T(a)(I) (1986).
57 Code Sec. 1092(a)(1)(A).
58 Code Sec. 1092(a)(1)(B).
59 Code Sec. 1092(d)(1).
60 Staff of the Joint Comm. on Taxation, 97th Cong., 1st Sess., *General Explanation of the Economic Recovery Tax Act of 1981*, at 289 (Joint Comm. Print 1981).
61 Code Sec. 1092(a)(1)(A).
62 *See* General Explanation of ERTA, at p 289.
63 Notice 2014-21, 2014-16 IRB 938, *supra* note 1, at A-1.
64 *Id*. at A-3.
65 Code Sec. 1092(a)(1); Regs. §§1.1092(b)-1T and -2T.
66 *See* Temporary Reg. §1.1092(b)-2T(b)(2) (1986).
67 *See* Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 304 and 316–317 (Joint Comm. Print 1984).
68 T.D. 9678, IRB 2014-32.
69 T.D. 9627, IRB 2013-35 (Doc 2013-18683).
70 Announcement 2013-45; IRB 2013-47 546.
71 Temporary Reg. §1.1092(b)-3T(c).
72 Temporary Reg. §1.1092(b)-4T(c)(4).
73 Code Sec. 475(f)(1).
74 Code Sec. 475(f)(2).
75 Code Sec. 475(c)(2).
76 Code Sec. 475(c)(2)(F)(ii).
77 Code Sec. 475(c)(2)(A); Reg. §1.1092(d)-1(c)(1).
78 For the definition of "trader" to be applied for these purposes, see *Chen*, 87 TCM (CCH) 1388, TC Memo. 2004-132, Dec. 55,653(M) (TC 2004); *Arberg*, 94 TCM (CCH) 215, Dec. 57,066(M), TC Memo. 2007-244; and *Holsinger*, 96 TCM (CCH) 85, TC Memo. 2008-191. *See also Bielfeldt*, CA-7, 2000-2 USTC ¶50,829, 231 F3d 1035.
79 *See also Paoli*, 54 TCM (CCH) 1574, 1578, Dec. 44,531(M), TC Memo. 1988-23.
80 *Groetzinger*, 87-1 USTC ¶9191, 480 US 23, 107 SCt 980.
81 There are wide variations between and hybrids of PoW and PoS blockchains.
82 Notice 2014-21, 2014-16 IRB, *supra* note 1, at Q&A-8, 9.
83 *See* discussion at Andrea S. Kramer, "The Legal Effect of IRS Pronouncements on VC," *On the Subject Bulletin of McDermott Will & Emery*, June 3, 2020, *www.mwe.com/insights/the-legal-effect-of-IRS-pronouncements-on-virtual-currency/*.
84 Taxpayers should consider Rev. Rul. 77-176, 1977 CB 77 and the oil and gas and mining industry responses with structuring tax partnerships to minimize the current taxability of certain extraction operations; *see* Bitkker and Lokken, *Federal Taxation of Income, Estates & Gifts*.
85 *Paoli*, *supra* note 79, at 1578 and *Chen*, *supra* note 78.
86 Code Sec. 162.
87 Notice 2014-21, 2014-16 IRB, *supra* note 1, at Q&A-9.
88 *See* discussion at Section IV.
89 *See* Chapter 10 of Publication 334, *Tax Guide for Small Business*, for more information on self-employment tax and Publication 535, *Business Expenses*, for more information on determining whether expenses are from a business activity carried to make a profit.
90 Non-U.S. taxpayers should carefully evaluate whether to file protective tax returns to prevent unpleasant U.S. tax surprises if they find themselves taxed on their gross income without an ability to deduct any of their losses and expenses.
91 Notice 2014-21, 2014-16 IRB, *supra* note 1, at Q&A 8.
92 Taxpayers should consider Rev. Rul. 77-176, 1977 CB 77 and the oil and gas and mining industry responses with structuring tax partnerships to minimize the current taxability of certain extraction operations; *see* Bitkker and Lokken, *Federal Taxation of Income, Estates & Gifts*.
93 *BNA Tax Portfolio, Oil and Gas Transactions*, No. 605, 2017, A-1.
94 *Glenshaw Glass*, SCt, 55-1 USTC ¶9308, 348 US 426, 75 SCt 473.
95 *Paoli* and *Chen*, *supra* notes 78 and 79.
96 Code Sec. 162.
97 *See* Chapter 10 of IRS Publication 334, *Tax Guide for Small Business*, for more information on self-employment tax and IRS Publication 535, *Business Expenses*.
98 *See Kovtun*, 54 TC 331, Dec. 29,975, *aff'd per curiam*, CA-9, 71-2 USTC ¶9647, 448 F2d 1268, *cert. denied*, SCt, 405 US 1016, 92 SCt 1290 (1972); *Titcher*, 57 TC 315, Dec. 31,102.
99 *Deputy v. DuPont*, SCt, 40-1 USTC ¶9161, 308 US 488, 60 SCt 363.
100 Code Sec. 61(a)(4).
101 *Old Colony Railroad Co.*, SCt, 3 USTC ¶880, 284 US 552, 52 SCt 211, *rev'g* CA-1, 50 F2d 896, *rev'g* 18 BTA 267, Dec. 5642 (1929).
102 Notice 2014-21, 2014-16 IRB 938, *supra* note 1, at Q&A-2.
103 *R.S. Stahl*, CA-DC, 70-2 USTC ¶9714, 441 F2d 999.
104 Code Sec. 1001(a).
105 Code Sec. 1058.
106 *Grodt & McKay Realty, Inc.*, 77 TC 1221, Dec. 38,472.
107 *See, e.g., Honeywell Inc.*, 64 TCM 437, Dec. 48,412(M), T.C. Memo. 1992-453 ("The passing of legal title is among the factors to be considered in determining whether a sale has occurred for Federal income tax purposes... Because it is only one factor, however, it is not determinative"); *see also Torres*, 88 TC 702, Dec. 43,809 ("in analyzing the transaction in this case, we first note that some of the factors enumerated in *Grodt & McKay Realty, Inc.* ... are either less relevant in this case or must be considered in a different light ...").
108 GCM 35183 (Jan. 2, 1973).
109 Reg. §1.1441-2(b)(2)(i).

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