



# Taxation of Crypto Gains and Losses

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## Panelists

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**Disclaimer**

# Review: Basics of Gains and Losses

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

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

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

Links to above - \_\_\_\_\_

Created Digital Assets

# Digital Assets From a Consensus Protocol Award

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

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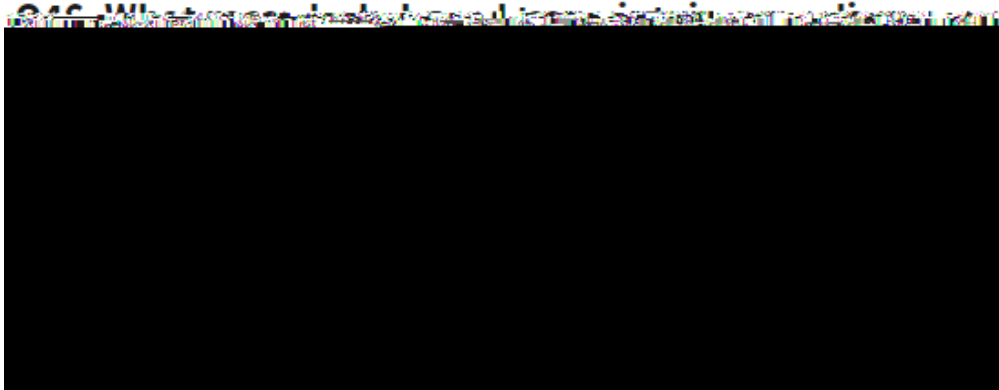
# Acquired Digital Assets Using Cash, Cryptocurrency, Goods, or Services

- Cryptocurrency acquired using (assuming these are arm's length transactions):
  - Cash: Basis = purchase price including any transaction fee
  -

## Acquired Digital Assets

- What is the value used to record the purchase and sale where one or both digital assets traded does not have a posted value?
  - [Rev. Rul. 81-251](#), 126 F.Supp. 184 (1954) – if arm’s length, use the part of the transaction that does have a known or determinable value.
  - FAQ 28
- How should the taxpayer keep track of crypto activities for their records?
  - For acquisition of digital assets by cash, other digital asset, goods or services, what documentation and information reporting form might they have? [see next slide]

# FAQ 46 on Recordkeeping



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

§6001 and regulations + §1001, et seq.

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## Dispositions of Digital Assets

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

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

Amount realized =

- Cash received
- + FMV of any property or services rec'd
- - transactions costs allocated to the sale or disposition of the transferred digital asset (Prop. 1.1001-1(b)(2))
- Where transaction costs arise in exchange of digital assets, treat 50% as part of acquisition (added to basis of DA acquired\*) and 50% as part of disposition.
- \*Prop. 1-1012-1(h)(2)
- Note - that if digital asset is used to pay transaction fee, calculate G/L on that disposition.
- <https://www.govinfo.gov/content/pkg/FR-2023-08-29/pdf/2023-17565.pdf>

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

- Appears to be directed at ETH Merge of Sept 2022
- On x date, Crypto X “changes its consensus mechanism used to select who may validate transactions and add blocks of transactions to the K blockchain from proof-of-work (“PoW”) to proof-of-stake(“PoS”) (the “protocol upgrade”).”
  - Does not affect transaction history
  - Owners continue to hold same # units
- Not an exchange under §1001 or *Rev. Rul. 85-136*, 499 US 554 (1991)
  - Only affects verification of future transactions
  - Existing units unchanged
  - Nothing new obtained
- **Query:** Isn't it relevant that PoS easier to engage in than PoW?
- **Observations:** CCAs non-binding. Result likely is a better one on what seems to be a close call.

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

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# Basis Tracking Where Multiple Units Held and Acquired at Different Times



Virtual FAQs 39 – 41  
[next slides]

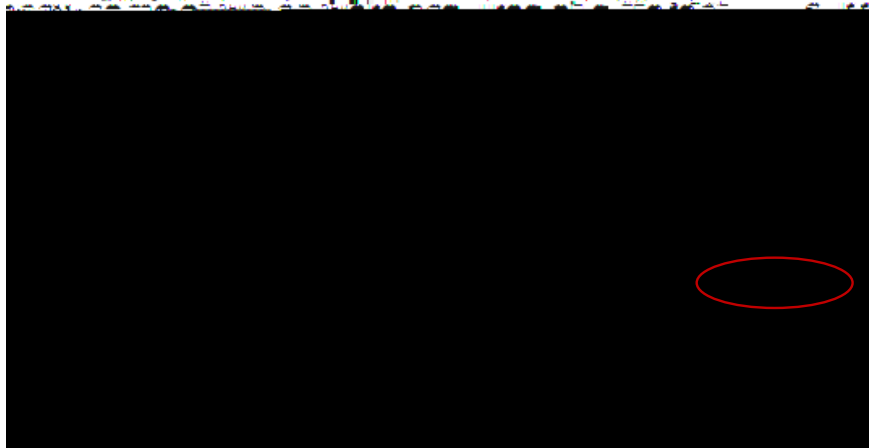


Proposed Reg.  
1.1012-1(h) & (j)

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

## FAQs 39 – 41 on Basis Issued Oct 2019

**Q39. I own multiple units of one kind of virtual**





# FAQs 39 – 41 on Basis

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

er by A40. You may identify a specific unit of virtual currency eit



# FAQs 39 – 41 on Basis

**Q41. How do I identify a specific unit of virtual currency?**

urrency, the units are A41. If you do not identify specific units of virtual c

ced to day or sold, exchanged, or otherwise disposed of a unit of the virtual currency— chronological order beginning with the earliest

unit of the virtual currency— chronological order beginning with the earliest

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

### Basis – General Observations:

- Identification of DA disposed of must be made in advance of transfer for basis reporting purposes.
- Identification must tie to DA in the same wallet.
- Specific identification approach is not considered a method of accounting.
  - Preamble: “prop

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

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

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## Prop. Reg. §1.1012-1(j)(1) and (2)

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

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## Prop. Reg. §1.1012-1(j)(1) and (2)

- (j)(3) [digital assets in custody of broker] – no later than time of transfer/disposition, taxpayer must provide broker with adequate

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## Effective date for §1001 and §1012 prop regs

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

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

### Exchange of digital assets for services

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

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

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

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

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

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

From AICPA comment letter:

- “Taxpayer D acquired multiple units of digital asset XYZ (a virtual currency) over several years. Some of these units are held in Taxpayer D's personal wallet, which he alone controls, while others were acquired

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# IRS List of Questions Includes for Basis Tracking ...

## Basis – One more consideration for many California digital asset investors

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

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

- Issue: If completed before 1/1/18, does exchange of
  - Bitcoin for Ether
  - Bitcoin for Litecoin
  - Ether for Litecoin
 Qualify as §1031 like-kind exchange?
- Conclusion: No
- Not like-kind because different traits.
  - §1.1031(a)-1(b) “like kind” look at nature or character of the property and not the grade or quality. “One kind or class of property may not be exchanged for property of a different kind or class.”
  - Bitcoin and Ether used to acquire other VCs; so different from Litecoin
  - Bitcoin and Ether differ in “overall design, intended use, and actual use”
    - Bitcoin – payments
    - Ethereum – also used for smart contracts and other applications

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

### *Observations:*

- Suggests traits relevant for §1031: overall design, intended use, actual use. Doesn't



# Disposition by Donation to Charity of DA Held for Investment

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

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

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

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

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

## Losses from Digital Assets

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

Crypto Losses and

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

Interesting items from IRS in this CCA:

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

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

More interesting items from IRS in this CCA:

- A took no steps to abandon crypto B including to permanently discard it from use.
- “Abandonment is proven through an evaluation of the surrounding facts and circumstances, which must show: (1) an intention to abandon the property, coupled with (2) an affirmative act of abandonment.”
- 

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# Crypto Losses and §165 – CCA 202302011

## *Observations:*

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

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# Crypto Losses and §165 – CCA 202302011

## *Open Issues:*

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

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## Crypto Theft Issue

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

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## Crypto Lending Activities

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

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# Crypto Lending Activities

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

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# Crypto Lending Activities

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

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# Crypto Lending Activities

## Crypto Lending Activities

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

# Tax Reporting Requirements

## Section 6050I / Announcement 2024-4

- Section 6050I requires that any person engaged in a trade or business that receives cash in excess of \$10,000 in a single transaction or in related transactions must file Form 8300 within 15 days.
- Infrastructure Investment and Jobs Act (IIJA) expanded the definition of cash to “digital assets” under §6045(g).
- IRS delayed implementation of the reporting under §6045.
-