IRS

Department of the Treasury
Internal Revenue Service
Privacy, Governmental Liaison and Disclosure
GLDS Support Services
Stop 93A
PO Box 621506
Atlanta, GA 30362

John Greenewald
The Black Vault Inc.
27305 W. Live Oak Rd. Suite#1203
Castaic, CA 91384

Date:
December 19, 2023
Employee name:
Tera Klinger
Employee ID number:
1000246154
Telephone number:
949-575-6034
Fax number:
855-205-9335
Case number:
2021-01180

Dear John Greenewald:

On December 7, 2023, I responded to your FOIA request dated February 14, 2020, received in our office on February 14, 2020.

In that response, I indicated the password and instructions to open the electronic media that contain the responsive records would be mailed separately.

To access the information on the electronic media, follow the steps below:

1. Double click the .pdf file or whatever format the documents are in on the electronic media to retrieve the documents.
2. Enter the password **Foia#01180** to decrypt your responsive documents.
3. Select Ok.

If you have questions, you can contact me at the telephone number shown at the top of this letter.

Sincerely,

Tera Klinger

Tera Klinger
Tax Law Specialist
Disclosure Office 13

Zepeda Carlos J

From: Cardone John V <[redacted] (b)(6)
Sent: Wednesday, August 14, 2019 11:24 AM
To: Zepeda Carlos J <[redacted] (b)(6)
Subject: FW: ITA Greensheet Circulation - Virtual Currency FAQs

I am to start a page using info from existing notice, and then add any guidance that comes out.
[redacted] (b)(5) Deliberative Process Privilege
Share with Bryan S.
Share mock-up with team on e-mail below

From: Goldstein Ronald J <[redacted] (b)(6)
Sent: Wednesday, August 14, 2019 9:34 AM
To: Cardone John V [redacted] (b)(6)
Cc: Stiernagle Bryan R <[redacted] (b)(6); Demetra Cathy R <[redacted] (b)(6); O'Dell Brendan T [redacted] (b)(6)
Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

Chris and I spoke with John Moriarty yesterday and he said the page title should use the virtual currency term. [redacted] (b)(5) Deliberative Process Privilege

---

From: Cardone John V
Sent: Wednesday, August 14, 2019 8:28 AM
To: Goldstein Ronald J
Cc: Stiernagle Bryan R; Demetra Cathy R; O'Dell Brendan T
Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

[redacted] (b)(5) Deliberative Process Privilege

Yes, we will publish on that page we discussed.

From: Goldstein Ronald J <[redacted] (b)(6)
Sent: Wednesday, August 14, 2019 8:15 AM
To: Cardone John V [redacted] (b)(6)
Cc: Stiernagle Bryan R <[redacted] (b)(6) Demetra Cathy R <[redacted] (b)(6); O'Dell Brendan T [redacted] (b)(6) Wrobel Christopher <[redacted] (b)(6); Sinno Suzanne R <[redacted] (b)(6); Yu James <[redacted] (b)(6)
Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

Hi John. [redacted] (b)(5) Deliberative Process Privilege

I received a question from Steve Schaeffer asking whether you and LBI will be the owner of the FAQs and publish on IRS.gov. That's my understanding but just wanted to confirm.

Zepeda Carlos J

From: Stiernagle Bryan R
Sent: Tuesday, August 20, 2019 9:32 AM
To: Zepeda Carlos J
Cc: Vu Linh M; Cincotta Karen S
Subject: FW: Virtual Currency Web Pages
Attachments: 2019 Virtual Currency 2019-0816 JC DRAFT.doc; 2019 Virtual Currency FAQs for Individuals 2019-0816 JC DRAFT.doc

Carlos,

I have provided the input I received from Karen below. Additionally, I added a few comments and a couple of tag words. Overall I agree with Karen. I took a stab at changing the intro in one of my comments. Let me know if you have any questions.

Bryan

From: Cincotta Karen S
Sent: Tuesday, August 20, 2019 8:19 AM
To: Stiernagle Bryan R [redacted] (b)(6)
Subject: RE: Virtual Currency Web Pages

Bryan,

The document for the FAQs had a duplicate word ("as") on page 4, Answer 22. Other than that error, the document for the FAQs was clear and flowed well.

I would suggest removing the first sentence of the 2019 Virtual Currency 2019-0816 JD DRAFT document. It is an awkward introduction otherwise I am ok with the narrative.

Karen Cincotta
[redacted] (b)(6)

Campaign development materials relate to examination selection standards; examination standards and the underlying data for determining such standards are protected under the law from disclosure. Access to these materials should be restricted, and in all cases these materials should not be shared beyond anyone that has a need to know.

From: Stiernagle Bryan R [redacted] (b)(6)
Sent: Monday, August 19, 2019 1:52 PM
To: Cincotta Karen S [redacted] (b)(6)
Subject: FW: Virtual Currency Web Pages

Karen,

Please let me know if you have any thoughts on the attached draft web page. I would not circulate these items at this point but just use them to provide feedback. My hope is to look at these tomorrow in more depth.

Bryan

From: Stiernagle Bryan R
Sent: Monday, August 19, 2019 3:49 PM
To: Zepeda Carlos J [redacted] (b)(6)
Cc: Vu Linh M <[redacted] (b)(6)
Subject: FW: Virtual Currency Web Pages

Carlos,

I am also going to have Karen Cincotta review this? I will try and look at this more closely tomorrow. [redacted] (b)(5) Deliberative Process Privilege

Bryan

From: Zepeda Carlos J
Sent: Monday, August 19, 2019 10:15 AM
To: Stiernagle Bryan R [redacted] (b)(6)
Cc: Vu Linh M <[redacted] (b)(6)
Subject: Virtual Currency Web Pages

Hi, Bryan – John C asked me to start a draft of a Virtual Currency web page, including a separate page for the related FAQs being circulated. [redacted] (b)(5) Deliberative Process Privilege

[redacted] (b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda **| LB&I | WIIC HQ-EA Staff | Office** [redacted] (b)(6) **| Fax 855-702-5018 | E-mail:** [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Cardone John V <[redacted] (b)(6)
Sent: Wednesday, August 14, 2019 11:24 AM
To: Zepeda Carlos J [redacted] (b)(6)
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Share mock-up with team on e-mail below

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Sent: Wednesday, August 14, 2019 9:34 AM

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Cc: Stiernagle Bryan R <(b)(6)>; Demetra Cathy R (b)(6); O'Dell Brendan T <(b)(6)>
Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

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Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

(b)(5) Deliberative Process Privilege

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Cc: Stiernagle Bryan R <(b)(6)>; Demetra Cathy R <(b)(6)>; O'Dell Brendan T <(b)(6)> Wrobel Christopher <(b)(6)> Sinno Suzanne R <(b)(6)>; Yu James <(b)(6)>
Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

Hi John. (b)(5) Deliberative Process Privilege

I received a question from Steve Schaeffer asking whether you and LBI will be the owner of the FAQs and publish on IRS.gov. That's my understanding but just wanted to confirm.

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of the Freedom of Information and Privacy Act

Zepeda Carlos J

From: Zepeda Carlos J
Sent: Tuesday, August 20, 2019 5:43 PM
To: Cardone John V
Cc: Vu Linh M
Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs
Attachments: 2019 Virtual Currency 2019-0820 CZ DRAFT v2.doc; 2019 Virtual Currency FAQs for Individuals 2019-0816 JC DRAFT.doc

Attached are 2 draft web pages for Virtual Currency, [redacted] (b)(5) Deliberative Process Privilege

PS SBSE already has a Virtual Currencies shell page and we can add these pages as links from their page.

Thanks.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Cardone John V <[redacted] (b)(6)
Sent: Wednesday, August 14, 2019 11:24 AM
To: Zepeda Carlos J [redacted] (b)(6)
Subject: FW: ITA Greensheet Circulation - Virtual Currency FAQs

8-15-2019 TC w/John
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Share with Bryan S. for input.
Share mock-up with team on e-mail below after John C review?

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Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

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Subject: RE: ITA Greensheet Circulation - Virtual Currency FAQs

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of the Freedom of Information and Privacy Act

Zepeda Carlos J

From: Cardone John V
Sent: Wednesday, August 21, 2019 4:47 AM
To: Williams Maha H; Demetra Cathy R
Cc: Zepeda Carlos J; Tuzynski John J; Vu Linh M
Subject: Virtual Currency Page on IRS.gov
Attachments: 2019 Virtual Currency 2019-0820 CZ DRAFT v2.doc; 2019 Virtual Currency FAQs for Individuals 2019-0816 JC DRAFT.doc

(b)(5) Deliberative Process Privilege

[redacted]

I asked Carlos to work on a page where we could summarized Virtual Currency resources and link to the FAQs etc. [redacted]

(b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

[redacted]

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of the Freedom of Information and Privacy Act

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of the Freedom of Information and Privacy Act

Zepeda Carlos J

From: Demetra Cathy R
Sent: Monday, August 26, 2019 11:59 AM
To: Cardone John V
Cc: Williams Maha H; Vu Linh M; Zepeda Carlos J; Tuzynski John J; Utzke David J
Subject: FW: Virtual Currency Page on IRS.gov

Hi John,

We'll be happy to work with you to update the content.

Cathy R. Demetra
FEGP Program Manager
Phone: [redacted] (b)(6)
FAX: (234) 232-3165
Cell: [redacted] (b)(6)

From: [redacted] (b)(6)
Sent: Wednesday, August 21, 2019 7:47 AM
To: Williams Maha H <[redacted] (b)(6); Demetra Cathy R <[redacted] (b)(6)
Cc: Zepeda Carlos J <[redacted] (b)(6) Tuzynski John J [redacted] (b)(6) Vu Linh M [redacted] (b)(6)
Subject: Virtual Currency Page on IRS.gov

[redacted] (b)(5) Deliberative Process Privilege

I asked Carlos to work on a page where we could summarized Virtual Currency resources and link to the FAQs etc. [redacted] (b)(5) Deliberative Process Privilege

[redacted] (b)(5) Deliberative Process Privilege

Zepeda Carlos J

From: Zepeda Carlos J
Sent: Wednesday, September 18, 2019 7:39 AM
To: Demetra Cathy R
Subject: RE: Virtual Currency Page on IRS.gov

Hi, Cathy – following up on the string of e-mails below regarding a new or modified web page for Virtual Currency. If you have a contact who is working on your Virtual Currencies page, I could work this matter with that person.

[redacted] (b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Demetra Cathy R <[redacted] (b)(6)
Sent: Monday, August 26, 2019 12:58 PM
To: Cardone John V <[redacted] (b)(6)
Cc: Zepeda Carlos J <[redacted]
Subject: RE: Virtual Currency Page on IRS.gov

[redacted] (b)(5) Deliberative Process Privilege

Cathy R. Demetra
FEGP Program Manager
Phone: [redacted] (b)(6)
FAX: (234) 232-3165
Cell: [redacted] (b)(6)

From: Cardone John V <[redacted] (b)(6)
Sent: Monday, August 26, 2019 3:52 PM
To: Demetra Cathy R <[redacted] (b)(6)
Cc: Zepeda Carlos J <[redacted]
Subject: RE: Virtual Currency Page on IRS.gov

So we have a plan –

[redacted] (b)(5) Deliberative Process Privilege

From: Demetra Cathy R <[redacted] (b)(6)
Sent: Monday, August 26, 2019 2:59 PM
To: Cardone John V <[redacted] (b)(6)

Cc: Williams Maha H (b)(6); Vu Linh M (b)(6); Zepeda Carlos J (b)(6); Tuzynski John J (b)(6) Utzke David J (b)(6)
Subject: FW: Virtual Currency Page on IRS.gov

Hi John,

We'll be happy to work with you to update the content.

Cathy R. Demetra
FEGP Program Manager
Phone: (b)(6)
FAX: (234) 232-3165
Cell: (b)(6)

From: Cardone John V (b)(6)
Sent: Wednesday, August 21, 2019 7:47 AM
To: Williams Maha H (b)(6); Demetra Cathy R (b)(6)
Cc: Zepeda Carlos J (b)(6) Tuzynski John J (b)(6); Vu Linh M (b)(6)
Subject: Virtual Currency Page on IRS.gov

(b)(5) Deliberative Process Privilege

I asked Carlos to work on a page where we could summarized Virtual Currency resources and link to the FAQs etc. (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

Zepeda Carlos J

From: Zepeda Carlos J
Sent: Wednesday, September 18, 2019 1:29 PM
To: Cardone John V
Subject: RE: Virtual Currency Web Page

Cathy just got back to me. I should soon have a contact to work with me.

Thanks.
Carlos

Carlos Zepeda **| LB&I | WIIC HQ-EA Staff | Office** [redacted] (b)(6) **| Fax 855-702-5018 | E-mail:** [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Cardone John [redacted] (b)(6)
Sent: Wednesday, September 18, 2019 1:21 PM
To: Zepeda Carlos J [redacted] (b)(6)
Subject: RE: Virtual Currency Web Page

[redacted] (b)(5) Deliberative Process Privilege

From: Zepeda Carlos J <[redacted] (b)(6)
Date: Wednesday, Sep 18, 2019, 4:01 PM
To: Cardone John V <[redacted] (b)(6)
Subject: FW: Virtual Currency Web Page

Well, full circle back to Cathy Demetra... I'll also share the e-mail from Ron G with Cathy.

Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Ronk Alice L <[redacted] (b)(6)
Sent: Wednesday, September 18, 2019 12:47 PM
To: Zepeda Carlos J <[redacted] (b)(6)
Cc: Ronk Alice L <[redacted] (b)(6)
Subject: RE: Virtual Currency Web Page

Hi Carlos: Cathy Demetra will be in touch with you. (She's in a meetings this week, so she may not be able to get back right away.)

From: Ronk Alice L <[redacted] (b)(6)
Sent: Wednesday, September 18, 2019 11:47 AM
To: Zepeda Carlos J <[redacted] (b)(6)
Cc: Ronk Alice L [redacted] (b)(6)
Subject: RE: Virtual Currency Web Page

Hi Carlos: I am happy to work with you. [redacted] (b)(5) Deliberative Process Privilege So, I will check with them to see how they would like to proceed. I will get back to you soon.
-Alice

____

From: Zepeda Carlos J <[redacted] (b)(6)
>
Sent: Wednesday, September 18, 2019 2:38 PM
To: Ronk Alice L <[redacted] (b)(6)
Subject: FW: Virtual Currency Web Page

[redacted] (b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Lyles Geinine A [redacted] (b)(6)
>
Sent: Wednesday, September 18, 2019 11:30 AM
To: Zepeda Carlos J [redacted] (b)(6)
Subject: RE: Virtual Currency Web Page

Carlos,

Alice Ronk is the owner of the Virtual Currency web page.

Geinine A. Lyles
Tax Analyst (Product and Market Development) & COR
IRS Communications & Liaison
Intranet & Digital Services Support Branch
801 Broadway, MDP 10
Nashville, TN 37203
Phone: [redacted] (b)(6)

From: Zepeda Carlos J <[redacted] (b)(6)
>
Sent: Wednesday, September 18, 2019 1:28 PM
To: Lyles Geinine A <[redacted] (b)(6)
Subject: Virtual Currency Web Page

Hi, Geinine - Do you happen to be the owner/SME of the Virtual Currencies <https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies> web page, or know who is? The SME on CMRS is listed as sbsewebcontent@irs.gov <mailto:sbsewebcontent@irs.gov> , but I do not have a name.

[redacted] (b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

Zepeda Carlos J

From: Zepeda Carlos J
Sent: Tuesday, October 01, 2019 7:28 AM
To: Goldstein Ronald J
Subject: FW: Virtual Currency Web Pages
Attachments: 2019 Virtual Currency 2019-0930 CZ DRAFT v4 ID 27000.doc; 2019 Virtual Currency FAQs for Individuals 2019-0930 JC ID 27000.doc

Importance: High

10-01-2019

(b)(5) Deliberative Process Privilege [redacted]

Attached are the updated Word drafts for you to revise and send back to me.

Thanks so much for your review.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Zepeda Carlos J
Sent: Monday, September 30, 2019 1:04 PM
To: Patterson Dean J < [redacted] (b)(6)
Cc: Goldstein Ronald J [redacted]
Subject: FW: Virtual Currency Web Pages

Hi, Dean – per our TC today, [redacted] (b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail:

[redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Zepeda Carlos J
Sent: Friday, September 27, 2019 10:59 AM
To: Stiernagle Bryan R <[redacted] (b)(6)
Cc: Cincotta Karen S <[redacted] (b)(6) Peil John M <[redacted] (b)(6)
Subject: FW: Virtual Currency Web Pages

Hi, Bryan – [redacted]

(b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda **| LB&I | WIIC HQ-EA Staff | Office** [redacted] (b)(6) **| Fax 855-702-5018 | E-mail:**
[redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Cardone John V <[redacted] (b)(6)
Sent: Friday, September 27, 2019 5:59 AM
To: Zepeda Carlos J <[redacted] (b)(6)
Cc: Vu Linh M <[redacted] (b)(6)
Subject: RE: Virtual Currency Web Pages

9-27-2019

[redacted] (b)(5) Deliberative Process Privilege

It looks great Carlos – [redacted]

(b)(5) Deliberative Process Privilege

From: Zepeda Carlos J [redacted] (b)(6)
Sent: Thursday, September 26, 2019 4:04 PM
To: Cardone John V [redacted] (b)(6)
Cc: Vu Linh M [redacted] (b)(6)
Subject: Virtual Currency Web Pages

Per your request, [redacted] (b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda **| LB&I | WIIC HQ-EA Staff | Office** [redacted] (b)(6) **| Fax 855-702-5018 | E-mail:** [redacted] (b)(6)
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of the Freedom of Information and Privacy Act

Withheld pursuant to exemption

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of the Freedom of Information and Privacy Act

Zepeda Carlos J

From: Cardone John V
Sent: Tuesday, October 01, 2019 11:26 AM
To: Zepeda Carlos J
Subject: FW: Status Update - Virtual Currency Guidance

10-01-2019:

[redacted] (b)(5) Deliberative Process Privilege

From: Zepeda Carlos J [redacted] (b)(6)
Sent: Tuesday, October 01, 2019 2:19 PM
To: Cardone John V [redacted] (b)(6)
Subject: RE: Status Update - Virtual Currency Guidance

[redacted] (b)(5) Deliberative Process Privilege

Thanks for the update.
Carlos

Carlos Zepeda | **LB&I** | **WIIC HQ-EA Staff** | **Office** [redacted] (b)(6) | **Fax 855-702-5018** | **E-mail:** [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Khoury Mireille T [redacted] (b)(6)
Sent: Tuesday, October 01, 2019 1:50 PM
To: Cardone John V [redacted] (b)(6)
Subject: FW: Status Update - Virtual Currency Guidance

From: Desmond Michael J
Sent: Tuesday, October 1, 2019 1:48 PM
To: Reynolds Jodie M [redacted] (b)(6)>; Lemons Terry L <[redacted] (b)(6); Eldridge Michelle L <[redacted] (b)(6); Moriarty John P <[redacted] (b)(6); Paul William M <[redacted] (b)(6) Lemons Terry L <[redacted] (b)(6) Wrobel Christopher <[redacted] Goldstein Ronald J <[redacted] (b)(6); Giuliano Amy F <[redacted] (b)(6) Lough Sunita B <[redacted] (b)(6); Cullinan Thomas A <[redacted] (b)(6) Rettig Charles P <[redacted] (b)(6); Flax Nikole C <[redacted] (b)(6); Khoury Mireille T <[redacted] (b)(6) Tonuzi Drita

[redacted] (b)(6)

Subject: Status Update - Virtual Currency Guidance

All –

[redacted] (b)(5) Deliberative Process Privilege

Thanks,

Mike

Michael J. Desmond
IRS Chief Counsel
[redacted] (b)(6)

Zepeda Carlos J

From: Zepeda Carlos J
Sent: Tuesday, October 01, 2019 12:00 PM
To: Utzke David J
Cc: Powell-Stringer Portia E; Demetra Cathy R; Ronk Alice L
Subject: 10/2 CC @ 7 am Virtual Currency w/SBSE: FEGP Webpage

10-02-2019 CC

(b)(5) Deliberative Process Privilege

Thanks.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office (b)(6) | Fax 855-702-5018 | E-mail:
(b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

-----Original Appointment-----
From: Utzke David J (b)(6)
Sent: Thursday, September 19, 2019 1:56 PM
To: Utzke David J; Powell-Stringer Portia E; Zepeda Carlos J; Demetra Cathy R
Subject: FEGP Webpage
When: Wednesday, October 02, 2019 7:00 AM-8:00 AM (UTC-07:00) Arizona.
Where: Conference call 888.331.8226,,,8707278#,,#

(b)(5) Deliberative Process Privilege

Please contact me if a different date and time are necessary.

Thanks,

David

David Utzke, PhD, MBA, MSc, CFE, CFI, CCE, CBE, CEE, CBD, CSCD, CDFE
SBSE HQ, FEGP Sr. Program Analyst - Digital Assets, DLT, & Alternative Payment Systems
Phone: [redacted] (b)(6)
eFax: 855.702.8175

From: Demetra Cathy R [redacted] (b)(6)
Sent: Thursday, September 19, 2019 9:17 AM
To: Utzke David J [redacted] (b)(6)
Cc: Ronk Alice L <[redacted]
Subject: RE: FEGP Webpage

Thanks David! Please reach out to Portia and Carlos to get this process started. Thanks!

Alice - cc'ing you as current page owner. We can work that issue.

From: Utzke David J [redacted] (b)(6)
Date: Thursday, Sep 19, 2019, 8:26 AM
To: Lyles Geinine A [redacted] (b)(6)
Cc: Demetra Cathy R [redacted] (b)(6)
Subject: RE: FEGP Webpage

Geinine, I appreciate the information.

Thanks.

David Utzke, PhD, MBA, MSc, CFE, CFI, CCE, CBE, CEE, CBD, CSCD, CDFE
SBSE HQ, FEGP Sr. Program Analyst - Digital Assets, DLT, & Alternative Payment Systems
Phone: [redacted] (b)(6)
eFax: 855.702.8175

From: Lyles Geinine A [redacted] (b)(6)
Sent: Thursday, September 19, 2019 7:14 AM
To: Utzke David J [redacted] (b)(6)
Subject: RE: FEGP Webpage

Good morning David,

[redacted] (b)(5) Deliberative Process Privilege If you need additional information, you can reach me on Skype.

Geinine A. Lyles
Tax Analyst (Product and Market Development) & COR
IRS Communications & Liaison
Intranet & Digital Services Support Branch
801 Broadway, MDP 10

Nashville, TN 37203
Phone: (b)(6)

From: Utzke David J (b)(6)
Sent: Wednesday, September 18, 2019 2:44 PM
To: Lyles Geinine A (b)(6)
Subject: FEGP Webpage

Hi, Geinine. Do you have a few moments to talk? I need to find out who the Communication Specialist is for the FEGP Virtual Currency webpage.

David Utzke, PhD, MBA, MSc, CFE, CFI, CCE, CBE, CEE, CBD, CSCD, CDFE
SBSE HQ, FEGP Sr. Program Analyst - Digital Assets, DLT, & Alternative Payment Systems
Phone: (b)(6)
eFax: 855.702.8175

Zepeda Carlos J

From: Demetra Cathy R
Sent: Wednesday, October 02, 2019 7:17 AM
To: Zepeda Carlos J
Cc: Utzke David J
Subject: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc
Attachments: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc

Follow Up Flag: Follow up
Flag Status: Completed

Hi Carlos,

As mentioned, please see attached. If you have questions, please feel free to contact David directly. Thanks!

Cathy

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of the Freedom of Information and Privacy Act

Withheld pursuant to exemption

(b)(5) Deliberative Process Privilege

of the Freedom of Information and Privacy Act

From: Demetra Cathy R
To: Zepeda Carlos J
Cc: Utzke David J; Cardone John V
Subject: RE: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc
Date: Wednesday, October 02, 2019 9:46:03 AM

[redacted] (b)(5) Deliberative Process Privilege

Cathy R. Demetra
FEGP Program Manager
Phone: [redacted] (b)(6)
FAX: (234) 232-3165
Cell: [redacted] (b)(6)

From: Zepeda Carlos J [redacted] (b)(6)
Sent: Wednesday, October 02, 2019 12:27 PM
To: Demetra Cathy R <Cathy.R.Demetra@irs.gov>
Cc: Utzke David J <David.Utzke@irs.gov>; Cardone John V <John.V.Cardone@irs.gov>
Subject: RE: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc

Hi, Cathy – Nice talking with you this morning. [redacted] (b)(5) Deliberative Process Privilege

Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Demetra Cathy R [redacted] (b)(6)
Sent: Wednesday, October 02, 2019 7:17 AM
To: Zepeda Carlos J [redacted] (b)(6)
Cc: Utzke David J [redacted] (b)(6)
Subject: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc

Hi Carlos,

As mentioned, please see attached. If you have questions, please feel free to contact David directly. Thanks!

Cathy

From: Utzke David J
To: Zepeda Carlos J
Cc: Cardone John V; Demetra Cathy R
Subject: RE: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc
Date: Wednesday, October 02, 2019 9:49:44 AM

Hi, Carlos.

(b)(5) Deliberative Process Privilege

Regards,

David Utzke, PhD, MBA, MSc, CFE, CFI, CCE, CBE, CEE, CBD, CSCD, CDFE
SBSE HQ, FEGP Sr. Program Analyst - Digital Assets, DLT, & Alternative Payment Systems
Phone: (b)(6)
eFax: 855.702.8175

From: Zepeda Carlos J (b)(6)
Sent: Wednesday, October 2, 2019 9:27 AM
To: Demetra Cathy R (b)(6)
Cc: Utzke David J (b)(6) Cardone John V (b)(6)
Subject: RE: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc

Hi, Cathy – Nice talking with you this morning.

(b)(5) Deliberative Process Privilege

Carlos

Carlos Zepeda | **LB&I** | **WIIC HQ-EA Staff** | **Office** (b)(6) | **Fax 855-702-5018** | **E-mail:** (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Demetra Cathy R [redacted] (b)(6)
Sent: Wednesday, October 02, 2019 7:17 AM
To: Zepeda Carlos J [redacted] (b)(6)
Cc: Utzke David J [redacted] (b)(6)
Subject: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000_FEGP review 2019-10-02.doc

Hi Carlos,

As mentioned, please see attached. If you have questions, please feel free to contact David directly. Thanks!

Cathy

From: Zepeda Carlos J
To: Trainer Claire E
Subject: Virtual Currency ID 27000: Virtual Currencies friendly URL and breadcrumbs
Date: Wednesday, October 09, 2019 8:57:00 AM
Attachments: 2019 Virtual Currency FAQs for Individuals 2019-1008 RG ID 27000.doc
2019 Virtual Currency 2019-1008 CZ DRAFT v8 ID 27000.doc
Importance: High

Hi, Claire – Please see attached for updates (mostly links) and please publish both pages!

Thanks.
Carlos

Carlos Zepeda **| LB&I | WIIC HQ-EA Staff | Office (b)(6) Fax 855-702-5018 | E-mail: (b)(6)**
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Trainer Claire E <(b)(6)
Sent: Friday, October 04, 2019 12:06 PM
To: Powell-Stringer Portia E <Portia.E.Powell-Stringer@irs.gov>
Cc: Demetra Cathy R <(b)(6); Solis Mark I <(b)(6) Lyles Geinine A <(b)(6); Zepeda Carlos J <(b)(6)
Subject: RE: Virtual Currencies friendly URL and breadcrumbs

Hi Portia,

Yes, we are going to use the current Virtual Currencies page on IRS.gov and overwrite it with the new content. (b)(5) Deliberative Process Privilege As an FYI, the friendly URL has been put in place: https://www.irs.gov/virtual_currency.

(b)(5) Deliberative Process Privilege

Claire

Claire Trainer
Senior Web Analyst
IRS Office of Online Services | Online Engagement, Operations and Media | Media Branch | SE:OLS:OEO:MED

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of the Freedom of Information and Privacy Act

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of the Freedom of Information and Privacy Act

(b)(6)

From: Powell-Stringer Portia E (b)(6)
Sent: Friday, October 4, 2019 1:56 PM
To: Trainer Claire E (b)(6)
Cc: Demetra Cathy R (b)(6); Solis Mark I (b)(6)>; Lyles Geinine A <(b)(6)
Subject: RE: Virtual Currencies friendly URL and breadcrumbs

(b)(5) Deliberative Process Privilege

Thanks

Portia Powell-Stringer

Public Affairs Specialist
Planning & Content Development, Section 2
Desk: (b)(6)

From: Trainer Claire E (b)(6)
Sent: Thursday, October 03, 2019 10:26 AM
To: Zepeda Carlos J (b)(6); Utzke David J (b)(6); Powell-Stringer Portia E (b)(6) Demetra Cathy R (b)(6)
Subject: Virtual Currencies friendly URL and breadcrumbs

All:

(b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

Thanks,
Claire

Claire Trainer
Senior Web Analyst
IRS Office of Online Services | Online Engagement, Operations and Media | Media Branch | SE:OLS:OEO:MED
(b)(6)

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Zepeda Carlos J

From: Zepeda Carlos J
Sent: Wednesday, October 09, 2019 10:57 AM
To: Cardone John V
Cc: Goldstein Ronald J; Wrobel Christopher; Demetra Cathy R; Stiernagle Bryan R; Patterson Dean J
Subject: RE: Press release on virtual currency - Draft

Press Release issued (IR-2019-167), and Virtual Currencies web page published. (FAQ link in the press release being updated to point to Virtual Currencies web page. It will all be transparent to external customers.)

Please get back to me if any updates needed to the web pages.

Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office (b)(6) | Fax 855-702-5018 | E-mail: (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

From: Cardone John V (b)(6)
Sent: Wednesday, October 09, 2019 6:38 AM
To: Zepeda Carlos J (b)(6)
Cc: Demetra Cathy R (b)(6)
Subject: FW: Press release on virtual currency - Draft

From: Reynolds Jodie M (b)(6)
Sent: Wednesday, October 09, 2019 8:50 AM
To: Desmond Michael J (b)(6)
Cc: Lemons Terry L (b)(6); Eldridge Michelle L (b)(6); O'Donnell Douglas W (b)(6); Hylton Eric C (b)(6); Flax Nikole C (b)(6); Guillot Darren John (b)(6); Harris Delon (b)(6); Khoury Mireille T (b)(6); Morris Angela (b)(6); Patterson Dean J (b)(6) Friedland Bruce I (b)(6); Cardone John V (b)(6); Grant Dianne (b)(6) Cullinan Thomas A (b)(6) Swartz Benjamin (b)(6); Paul William M; Moriarty John P (b)(6); Wrobel Christopher (b)(6); Giuliano Amy F (b)(6)
Subject: RE: Press release on virtual currency - Draft

We will get everything out and posted. I will send you the link once everything has posted. Thanks – Jodie

---

From: Desmond Michael J (b)(6)
Sent: Wednesday, October 9, 2019 8:47 AM
To: Reynolds Jodie M (b)(6)
Cc: Lemons Terry L (b)(6); Eldridge Michelle L (b)(6); O'Donnell Douglas W (b)(6); Hylton Eric C (b)(6); Flax Nikole C (b)(6); Guillot Darren John (b)(6); Harris Delon (b)(6); Khoury Mireille T (b)(6); Morris Angela (b)(6); Patterson Dean J (b)(6)

Friedland Bruce I <[redacted] (b)(6)>; Reynolds Jodie M [redacted] (b)(6)>; Cardone John V <[redacted] (b)(6)>; Grant Dianne <[redacted] (b)(6)>; Cullinan Thomas A <[redacted] (b)(6)>; Swartz Benjamin <[redacted] (b)(6)>; Paul William M <[redacted] (b)(6)>; Moriarty John P <[redacted] (b)(6)>; Wrobel Christopher <[redacted] (b)(6)>; Giuliano Amy F <[redacted] (b)(6)
Subject: RE: Press release on virtual currency - Draft

Jodie:

We are cleared to issue the virtual currency press release, revenue ruling and FAQs, please post this morning if possible.

Thanks,

Mike

From: Desmond Michael J
Sent: Tuesday, October 08, 2019 6:53 PM
To: Reynolds Jodie M
Cc: Lemons Terry L; Eldridge Michelle L; O'Donnell Douglas W; Hylton Eric C; Flax Nikole C; Guillot Darren John; Harris Delon; Khoury Mireille T; Morris Angela; Patterson Dean J; Friedland Bruce I; Reynolds Jodie M; Cardone John V; Grant Dianne; Cullinan Thomas A; Swartz Benjamin
Subject: RE: Press release on virtual currency - Draft

Jodie,

[redacted] (b)(5) Deliberative Process Privilege

Thanks,

Mike

Michael J. Desmond
IRS Chief Counsel
[redacted] (b)(6)

From: Reynolds Jodie M
Sent: Wednesday, September 25, 2019 8:30 AM
To: Cardone John V; Grant Dianne; Cullinan Thomas A; Swartz Benjamin
Cc: Lemons Terry L; Eldridge Michelle L; O'Donnell Douglas W; Hylton Eric C; Desmond Michael J; Flax Nikole C; Guillot Darren John; Harris Delon; Khoury Mireille T; Morris Angela; Patterson Dean J; Friedland Bruce I; Reynolds Jodie M
Subject: Press release on virtual currency - Draft

[redacted] (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

Cardone John V

From: Cardone John V
Sent: Wednesday, February 12, 2020 3:10 PM
To: Zepeda Carlos J
Cc: Stiernagle Bryan R
Subject: Language on Virtual Currency Page

(b)(5) Deliberative Process Privilege

Cardone John V

From: Cardone John V
Sent: Wednesday, February 12, 2020 3:43 PM
To: Friedland Bruce I
Cc: Patterson Dean J; Fiebich Barbara J; Goldstein Ronald J; Wrobel Christopher; Drenthe Pamela J
Subject: RE: MEDIA INQUIRY: Fortnite V-Bucks - Listed for Virtual Currency
Attachments: 2019 Virtual Currency 2019-0820 CZ DRAFT v2.doc; 2020 0212 Screen Shot.pdf

(b)(5) Deliberative Process Privilege
[redacted]

~*~

From: Drenthe Pamela J [redacted] (b)(6)
Sent: Wednesday, February 12, 2020 2:06 PM
To: Friedland Bruce I [redacted] (b)(6) Cardone John V [redacted] (b)(6)
Cc: Patterson Dean J [redacted] (b)(6) Drenthe Pamela J [redacted] (b)(6) Fiebich Barbara J [redacted] (b)(6)
Subject: RE: MEDIA INQUIRY: Fortnite V-Bucks - Listed for Virtual Currency

John,

I think this is a similar question to the one you are addressing. Thoughts?

Pamela Drenthe
Director, Exam Quality and Technical Support,
SBSE Examination
Phone [redacted] (b)(6)
E-Fax (855) 787-3594

From: Friedland Bruce I [redacted] (b)(6)
Sent: Wednesday, February 12, 2020 10:29 AM
To: Drenthe Pamela J [redacted] (b)(6)
Cc: Patterson Dean J <[redacted]
Subject: MEDIA INQUIRY: Fortnite V-Bucks - Listed for Virtual Currency

Pam,

(b)(5) Deliberative Process Privilege
[redacted]

Can you point us to the right person?

Bruce Friedland
IRS Media Relations
[redacted] (b)(6)

Hi folks,

(b)(5) Deliberative Process Privilege
[redacted]

Brian

Cardone John V

From: Cardone John V
Sent: Wednesday, February 12, 2020 3:53 PM
To: Flax Nikole C; O'Donnell Douglas W
Cc: Cardone John V
Subject: Virtual Currency -- Changes to Website Will Get Picked up by Press
Attachments: 2019 Virtual Currency 2019-0820 CZ DRAFT v2.doc; 2020 0212 Screen Shot.pdf

(b)(5) Deliberative Process Privilege
[redacted]

From: Cardone John V [redacted] (b)(6)
Sent: Wednesday, February 12, 2020 3:43 PM
To: Friedland Bruce I <[redacted] (b)(6)>
Cc: Patterson Dean J <[redacted] (b)(6)>; Fiebich Barbara J <[redacted] (b)(6)>; Goldstein Ronald J [redacted] (b)(6); Wrobel Christopher <[redacted] (b)(6)>; Drenthe Pamela J <[redacted] (b)(6)>
Subject: RE: MEDIA INQUIRY: Fortnite V-Bucks - Listed for Virtual Currency

(b)(5) Deliberative Process Privilege
[redacted]

(b)(5) Deliberative Process Privilege [redacted]

~*~

From: Drenthe Pamela J [redacted] (b)(6)
Sent: Wednesday, February 12, 2020 2:06 PM
To: Friedland Bruce I [redacted] (b)(6) Cardone John V [redacted] (b)(6)
Cc: Patterson Dean J [redacted] Drenthe Pamela J [redacted] Fiebich Barbara J [redacted] (b)(6)
Subject: RE: MEDIA INQUIRY: Fortnite V-Bucks - Listed for Virtual Currency

John,

I think this is a similar question to the one you are addressing. Thoughts?

Pamela Drenthe
Director, Exam Quality and Technical Support,
SBSE Examination
Phone [redacted] (b)(6)
E-Fax (855) 787-3594

From: Friedland Bruce I [redacted] (b)(6)
Sent: Wednesday, February 12, 2020 10:29 AM
To: Drenthe Pamela J [redacted] (b)(6)
Cc: Patterson Dean J [redacted]
Subject: MEDIA INQUIRY: Fortnite V-Bucks - Listed for Virtual Currency

Pam,

(b)(5) Deliberative Process Privilege [redacted]

Can you point us to the right person?

Bruce Friedland
IRS Media Relations
[redacted] (b)(6)

Hi folks,

(b)(5) Deliberative Process Privilege

[redacted]

Brian

Page 096

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IRS

Virtual Currencies

Virtual currency transactions are taxable by law just like transactions in any other property. Taxpayers transacting in virtual currency may have to report those transactions on their tax returns.

What is Virtual Currency?

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in the U.S. Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain, DAG, or Tempo.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin, Ether, Roblox, and V-bucks are a few examples of a convertible virtual currency. Virtual currencies can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

Tax Consequences

The sale or other exchange of virtual currencies, or the use of virtual currencies to pay for goods or services, or holding virtual currencies as an investment, generally has tax consequences that could result in tax liability.

The IRS issued IRS Notice 2014-21, IRB 2014-16, as guidance for individuals and businesses on the tax treatment of transactions using virtual currencies.

The IRS also published Frequently Asked Questions on Virtual Currency Transactions for individuals who hold cryptocurrency as a capital asset and are not engaged in the trade or business of selling cryptocurrency.

References/Relate
Topics

- Revenue Ruling 2019-24 (PDF)
- IRS reminds taxpayers to report virtual currency transactions, IR-2018-71, March 23, 2018
- Virtual Currency Compliance campaign, July 2, 2018
- IRS has begun sending letters to virtual currency owners advising them to pay back taxes, file amended returns; part of agency's larger efforts, IR-2019-132, July 26, 2019
- LB&I Campaign Letter 6173 (PDF)
- LB&I Campaign Letter 6174 (PDF)
- LB&I Campaing Letter 6174-A (PDF)

More Information

For more information regarding the general tax principles that apply to virtual currencies, you can also refer to the following IRS Publications:

- Publication 525, Taxable and Nontaxable Income, for more information on miscellaneous income from exchanges involving property or services,
- Publication 526, Charitable Contributions, for more information on charitable contribution deductions,
- Publication 544, Sales and Other Dispositions of Assets, for more information about capital assets and the character of gain or loss,
- Publication 551, Basis of Assets, for more information on computation of basis, and
- Publication 561, Determining the Value of Donated Property, for more information on the appraisal of donated property worth more than $5,000.

Page Last Reviewed or Updated: 20-Dec-2019

Cardone John V

From: Cardone John V
Sent: Wednesday, February 12, 2020 5:09 PM
To: Friedland Bruce I; Drenthe Pamela J; Stiernagle Bryan R; Goldstein Ronald J; Wrobel Christopher
Cc: Lemons Terry L; Eldridge Michelle L; Reynolds Jodie M; Flax Nikole C [redacted] (b)(6); O'Donnell Douglas W
Subject: DRAFT STATEMENT: Changes to the Virtual Currency Page

I'm fine with this.

From: Friedland Bruce I <[redacted] (b)(6)
Sent: Wednesday, February 12, 2020 4:39 PM
To: Drenthe Pamela J <[redacted] (b)(6); Cardone John V <[redacted] (b)(6); Stiernagle Bryan R <[redacted] (b)(6); Goldstein Ronald J <[redacted] (b)(6); Wrobel Christopher <[redacted] (b)(6)
Cc: Lemons Terry L <[redacted] (b)(6); Eldridge Michelle L <[redacted] (b)(6); Reynolds Jodie M [redacted] (b)(6)
Subject: DRAFT STATEMENT: Changes to the Virtual Currency Page

[redacted] (b)(5) Deliberative Process Privilege

Bruce

[redacted] (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

Cardone John V

From: Cardone John V
Sent: Thursday, February 13, 2020 11:05 AM
To: Drenthe Pamela J
Cc: Friedland Bruce I
Subject: FW: Language on Virtual Currency Page
Attachments: Done-2019 Virtual Currency 2019-1002 CZ DRAFT v7 ID 27000.doc; Done-2019 Virtual Currency 2019-1002 CZ DRAFT v6 ID 27000.doc; FW: 2019 Virtual Currency 2019-1001 CZ DRAFT v4 ID 27000 _FEGP review 2019-10-02.doc

They did originate from David – but I was in the email chain. The language has been there since we originally posted the FAQs in October.

From: Zepeda Carlos J <[redacted] (b)(6)
Sent: Thursday, February 13, 2020 10:43 AM
To: Cardone John V [redacted] (b)(6)
Cc: Stiernagle Bryan R <[redacted] (b)(6); Vu Linh M <[redacted] (b)(6)
Subject: RE: Language on Virtual Currency Page
Importance: High

Hi, John – The attached v6 shows the updates requested by David U, and v7 shows further updates requested by David U.

Per previous e-mail I sent you, they were shared with you and Cathy D, so I made the updates on the internet page you reference below.
Carlos

Carlos Zepeda | LB&I | WIIC HQ-EA Staff | Office [redacted] (b)(6) | Fax 855-702-5018 | E-mail: [redacted] (b)(6)
Internal Revenue Service, 4830 Business Center Drive, Ste 250, Fairfield, CA 94534-1689

Cardone John V

From: Cardone John V
Sent: Friday, February 14, 2020 7:50 AM
To: Friedland Bruce I
Cc: Wrobel Christopher; Goldstein Ronald J; Lemons Terry L; Flax Nikole C (b)(6); Drenthe Pamela J; Eldridge Michelle L; Reynolds Jodie M
Subject: Virtual Currency

(b)(5) Deliberative Process Privilege

From: Desmond Michael J <(b)(6)>
Sent: Thursday, February 13, 2020 9:33 PM
To: Flax Nikole C <(b)(6)>
Cc: Cullinan Thomas A <(b)(6)>; Cardone John V <(b)(6)>; O'Donnell Douglas W <(b)(6)>
Subject: RE: Virtual Currency

Nikole,

(b)(5) Deliberative Process Privilege

Thanks,
Mike

(b)(5) Deliberative Process Privilege

From: Flax Nikole C
Sent: Thursday, February 13, 2020 8:37 PM
To: Desmond Michael J
Cc: Cullinan Thomas A; Cardone John V; O'Donnell Douglas W
Subject: RE: Virtual Currency

(b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

From: Desmond Michael J <(b)(6)>
Sent: Thursday, February 13, 2020 5:57 PM
To: Flax Nikole C <(b)(6)>
Cc: Cullinan Thomas A <(b)(6)>; Cardone John V <(b)(6)>
Subject: Virtual Currency

Nikole,

(b)(5) Deliberative Process Privilege

Thanks,

Mike

Michael J. Desmond
IRS Chief Counsel
(b)(6)

Cardone John V

From: Cardone John V
Sent: Friday, February 14, 2020 8:45 AM
To: Friedland Bruce I
Subject: Virtual Currency

See Goldstein's comment. [redacted] (b)(5) Deliberative Process Privilege

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From: Goldstein Ronald J [redacted] (b)(6)
Sent: Friday, February 14, 2020 8:31 AM
To: Cardone John V <[redacted] (b)(6)
Cc: Wrobel Christopher <[redacted] (b)(6)
Subject: RE: Virtual Currency

Good morning John. [redacted] (b)(5) Deliberative Process Privilege

---

From: Cardone John V
Sent: Friday, February 14, 2020 7:50 AM
To: Friedland Bruce I <[redacted] (b)(6)
Cc: Wrobel Christopher <[redacted] (b)(6)>; Goldstein Ronald J <[redacted] (b)(6); Lemons Terry L [redacted] (b)(6); Flax Nikole C <[redacted] (b)(6); Drenthe Pamela J <[redacted] (b)(6) Eldridge Michelle L [redacted] (b)(6)>; Reynolds Jodie M <[redacted] (b)(6)>
Subject: Virtual Currency

[redacted] (b)(5) Deliberative Process Privilege

From: Desmond Michael J <[redacted] (b)(6)
Sent: Thursday, February 13, 2020 9:33 PM
To: Flax Nikole C <[redacted] (b)(6)
Cc: Cullinan Thomas A <[redacted] (b)(6) Cardone John V <[redacted] (b)(6) O'Donnell Douglas W <[redacted] (b)(6)
Subject: RE: Virtual Currency

Nikole,
[redacted] (b)(5) Deliberative Process Privilege
Thanks,
Mike

[redacted] (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege [redacted]

From: Flax Nikole C
Sent: Thursday, February 13, 2020 8:37 PM
To: Desmond Michael J
Cc: Cullinan Thomas A; Cardone John V; O'Donnell Douglas W
Subject: RE: Virtual Currency

(b)(5) Deliberative Process Privilege [redacted]

From: Desmond Michael J <[redacted] (b)(6)
Sent: Thursday, February 13, 2020 5:57 PM
To: Flax Nikole C <[redacted] (b)(6)
Cc: Cullinan Thomas A [redacted] (b)(6); Cardone John V <[redacted] (b)(6)
Subject: Virtual Currency

Nikole,

(b)(5) Deliberative Process Privilege [redacted]

Thanks,

Mike

Michael J. Desmond
IRS Chief Counsel

(b)(6)

The New York Times https://nyti.ms/2G5klsu

Opinion | OP-ED CONTRIBUTORS

Why the I.R.S. Fears Bitcoin

By RICHARD HOLDEN and ANUP MALANI JAN. 22, 2018

The extraordinary rise in the value of Bitcoin and other cryptocurrencies has led many people to worry that this market is a giant bubble. Many, including the Federal Reserve chairwoman Janet Yellen and the billionaire investor Warren Buffett, have warned about a "Bitcoin bust" that could rival the dot-com crash of 2000 and wipe out speculators.

But the bigger concern about cryptocurrencies may be the damage they could do, in the long run, to government finances through lost tax revenue.

The core technology underlying cryptocurrencies, known as blockchain, is premised on anonymity: Transactions are public but linked only to an electronic address. This is a big part of what makes blockchain attractive.

But anonymity is also the main fuel for the underground economy, which is now conducted largely via cash. The underground economy is a significant source of lost tax revenue. The Internal Revenue Service estimates that it loses around $500 billion annually because of unreported wages alone. And the underground economy in the United States — estimated at 8.4 percent of output — is relatively small compared with those of other countries.

If cryptocurrencies were to replace cash as the preferred anonymous medium of exchange, they could significantly expand the underground economy because they are so much more convenient than cash. There is no need to visit an A.T.M., and you can securely pay people regardless of their locatio SEE MY OPTIONS Steven Mnuchin, the

Treasury secretary, expressed concerns recently that Bitcoin could become "the next Swiss bank account."

The I.R.S. understands this, which is why it has been pushing to break the anonymity of cryptocurrencies. In November, it persuaded a federal judge to order Coinbase, a popular Bitcoin exchange, to reveal the identity of the customers for more than 14,000 accounts (representing nearly nine million transactions).

Blockchain technologies can also make it difficult for the I.R.S. to tax cryptocurrency trading profits. Here is a simple tax dodge that would be hard for the I.R.S. to prove: Suppose A, B and C are electronic addresses you own. You let the I.R.S. know you own A, but not B and C. You buy one Bitcoin at $15,000 and park it at A, expecting the price to go up. Just a few hours later, when a Bitcoin is worth $15,500, you send that Bitcoin to B and then to C.

A few months later, when your Bitcoin is now worth $25,000, you send it from C to A and tell the I.R.S., "I sold a Bitcoin to an anonymous counterparty at B back at $15,500 and just now bought a Bitcoin from another anonymous counterparty at C for $25,000." As a result, you owe taxes on capital gains of just $500 rather than $10,000.

The I.R.S. can observe all the transactions between A, B and C on the Bitcoin blockchain, but it cannot disprove that B and C are "arm's length" counterparties (that is, independent and not colluding). Rules in the United States that require financial institutions to verify the identity of address holders do not solve the problem, because as far as the I.R.S. knows, B and C could have been set up by a foreign institution that does not comply with such rules.

It is inconceivable that the government would simply accept enormous revenue losses from a larger underground economy and from tax dodges on trading profits. The only question is how heavy-handed the response would be.

One approach would be for the government to accept the difficulty of directly taxing cryptocurrency transactions and to offset the revenue losses by raising tax rates. The basic economics of taxation tells us that the economic losses from taxes increase exponentially with the tax rate, so this response would transform revenue losses into a lower gross domestic product.

More likely, the United States would take a tougher approach and attempt to ban cryptocurrencies. This solution throws the baby out with the bath water. While cryptocurrencies open opportunities for tax evasion and illegal operations, they also offer drastic reductions in the cost of financial transactions, especially for the poor, and less reliance on banks, which can increase the power of the Federal Reserve to control money supply and reduce the risk of bank runs.

A smarter response would be for the government to switch from taxing income when it is received to taxing income when it is spent. Many economists support moving to this kind of consumption tax, but it would require a major overhaul of the tax code.

The prospect of substantial government revenue losses is not just a problem for the United States government; it is also a problem for the cryptocurrencies themselves. For cryptocurrencies to survive long enough to be an effective means of performing everyday transactions, the cryptocurrency community will need to find a way to prevent tax evasion. This will involve a tricky balancing act, preserving anonymity while providing the I.R.S. with sufficient information to prevent tax evasion.

More generally, cracking down on tax evasion will require that the community learn to trust government. Since this goes against the very ethos of the cryptocurrency movement, it poses the most difficult — but no less necessary — challenge.

Richard Holden is a professor of economics at the business school of the University of New South Wales. Anup Malani is a law professor at the University of Chicago.

A version of this op-ed appears in print on January 23, 2018, on Page A25 of the New York edition with the headline: Why the I.R.S. Fears Bitcoin

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20 DTR I-1

Virtual Currency

Crypto as 'Next Swiss Bank Account' Sends Governments Scrambling

By Rob Urban

Authorities around the world worry that cryptocurrencies could become tax havens.

Too late. It's already happening.

Take David Drake, whose New York-based family office has more than $10 million in cryptocurrency and blockchain investments. He's using digital money like an offshore bank account—a place to legally park overseas business profits and reduce U.S. taxes.

British Prime Minister Theresa May and Indian Prime Minister Narendra Modi are among the world leaders who've expressed alarm at the rise of virtual cash to move money offshore. The U.S. Congress held hearings this month, and Treasury Secretary Steven Mnuchin called on the world's 20 biggest economies to work together to make sure cryptocurrencies don't "become the next Swiss bank account." The concern comes after a successful international crackdown on tax havens in traditional banking.

Snapshot

- Digital currency gets a piece of $10 trillion in hidden assets
- New virtual money ZCash uses encryption to ensure privacy

David Drake

Source: LDJ Capital

"Every country is scrambling to come up with an answer," said Drake, who serves on the boards of 25 public and private companies. "There needs to be a regulated structure that won't kill the industry."

The earliest adopters of the practice were criminals, and their involvement has risen steadily, according to a three-year study by the Foundation for Defense of Democracies, a non-partisan Washington think tank. Next came users like Drake, who said he follows U.S. law by reporting his companies' holdings. Drake said better oversight would help legitimize the industry.

Rising Demand

There's demand for fresh ways to hide assets after U.S. and European regulators clamped down on traditional banks. They've ramped up enforcement of "know-your-customer" and anti-money-laundering rules and forced offshore financial institutions to disclose client information. The campaign prompted many mainstream financial firms to limit customers' access to Switzerland's secretive banking system. That's made it harder to hide funds from the government, courts, spouses or other prying eyes back home.

Cryptocurrency exchanges are covered by the rules, but enforcement hasn't been consistent, particularly outside the U.S.

The use of virtual money to store assets offshore is evolving rapidly, with the introduction of so-called privacy coins, such as ZCash and Monero, which use methods like encryption to make them untraceable. About $10 trillion is held offshore worldwide, according to Grayscale Investments, a New York-based firm that's offering a ZCash Trust to investors. ZCash could capture as much as 10 percent of that by 2025, said Grayscale's Matthew Beck.

"This is the first time anyone in the world can store their cash privately and be their own bank," Beck said. "Privacy is a dwindling resource and one that people are going to be willing to pay for."

Even though ZCash touts the impenetrability of its encryption technology, Beck argues that government oversight is still needed.

"We don't think this ecosystem can grow without regulation," Beck said.

Can Be Traced

Bitcoin, the most popular cryptocurrency, is anonymous, though it can be traced, with the electronic public ledger called blockchain keeping track of every transaction. Even though all that's revealed of buyers and sellers are strings of letters and numbers, law enforcement has developed technology to track and seize illicit Bitcoins.

Existing laws require banks to report suspicious activity, including withdrawals of more than $9,999, while digital-currency exchanges are required to keep customer records and take similar measures. Once Bitcoin is purchased, there's software that can detect patterns and trace the owner, said Kerry Myers, clinical professor of forensic accounting and law at the Lynn Pippenger School of Accountancy at the University of South Florida in Tampa.

Can't Stomp It

The Foundation for Defense of Democracies' money laundering study recommends that governments go after criminal uses of cryptocurrencies, but at the same time respect financial innovation. Most of all, the study said, regulators shouldn't kid themselves about their ability to completely stomp it out. They can't.

"Maybe we need to look at the lessons learned from other payment systems," said Yaya Fanusie, who co-authored the study. "When credit cards came out, there was abuse, there were scams, there still are. But we figured out how to deal with them."

The study looked at money laundering through Bitcoin ATMs, exchanges, gambling sites and mixers—services that convert one digital currency to another—and found that illicit uses rose steadily between 2013 and 2016, the time range of its research.

The study also found that conversion services based in Europe took in the biggest share of illicit Bitcoins, more than five times as much as North American services. Asia had a very small share of laundering, even though services in that region had the most transactions.

Any regulations would have to walk the fine line between protecting national taxation interests and allowing cryptocurrencies to continue to innovate and flourish, Drake said.

"We need to distinguish between legal and illegal activities," he said.

To contact the reporter on this story: Rob Urban in New York at robprag@bloomberg.net

To contact the editors responsible for this story: Bob Ivry at bivry@bloomberg.net David Scheer

ISSN 1522-8800

125 S.Ct. 826
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, Petitioner,
v.
John W. BANKS, II.
Commissioner of Internal Revenue, Petitioner,
v.
Sigitas J. Banaitis.

Nos. 03-892, 03-907.
|
Argued Nov. 1, 2004.
|
Decided Jan. 24, 2005.

Synopsis
Background: In separate actions, taxpayers petitioned for redetermination of taxability of litigation settlement proceeds. In both cases, the United States Tax Court, 2001 WL 196751 and 2002 WL 22018, upheld taxation of portion of recovery paid to taxpayers' attorneys as contingent fees. Taxpayers appealed. In both cases, the United States Courts of Appeals for the Sixth Circuit, Clay, Circuit Judge, 345 F.3d 373, and for the Ninth Circuit, Thomas, Circuit Judge, 340 F.3d 1074, reversed on the attorney fee issue. Certiorari was granted.

[Holding:] The Supreme Court, Justice Kennedy, held that when litigant's recovery constitutes taxable income, such income includes portion of recovery paid to litigant's attorney as contingent fee.

Reversed and remanded.

Chief Justice Rehnquist took no part in decision.

****826 *426** *Syllabus* [*]

Respondent Banks settled his federal employment discrimination suit against a California state agency and respondent Banaitis settled his Oregon state case against his former employer, but neither included fees paid to their attorneys under contingent-fee agreements as gross income on their federal income tax returns. In each case petitioner Commissioner of Internal Revenue issued a notice of deficiency, which the Tax Court upheld. In ****827** Banks' case, the Sixth Circuit reversed in part, finding that the amount Banks paid to his attorney was not includable as gross income. In Banaitis' case, the Ninth Circuit found that because Oregon law grants attorneys a superior lien in the contingent-fee portion of any recovery, that part of Banaitis' settlement was not includable as gross income.

Held: When a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. Pp. 830-834.

(a) Two preliminary observations help clarify why this issue is of consequence. First, taking the legal expenses as miscellaneous itemized deductions would have been of no help to respondents because the Alternative Minimum Tax establishes a tax liability floor and does not allow such deductions. Second, the American Jobs Creation Act of 2004-which amended the Internal Revenue Code to allow a taxpayer, in computing adjusted gross income, to deduct attorney's fees such as those at issue-does not apply here because it was passed after these cases arose and is not retroactive. Pp. 830-831.

(b) The Code defines "gross income" broadly to include all economic gains not otherwise exempted. Under the anticipatory assignment of income doctrine, a taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party, *e.g., Lucas v. Earl,* 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731, because gains should be taxed "to those who earned them," *id.,* at 114, 50 S.Ct. 241. The doctrine is meant to prevent taxpayers from avoiding taxation through arrangements and contracts devised to prevent ***427** income from vesting in the one who earned it. *Id.,* at 115, 50 S.Ct. 241. Because the rule is preventative and motivated by administrative and substantive concerns, this Court does not inquire whether any particular assignment has a discernible tax avoidance purpose. P. 831.

(c) The Court agrees with the Commissioner that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. In an ordinary case attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. However, in the context of anticipatory assignments, where the assignor may not have dominion over the income at the moment of receipt, the question is whether the assignor retains dominion over the income-generating asset. Looking to such control preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits. In the case of a litigation recovery the income-generating asset is the cause of action derived from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. Respondents' counterarguments are rejected. The legal claim's value may be speculative at the moment of the assignment, but the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance. In these cases, the taxpayer retained control over the asset, diverted some of the income produced to another party, and realized a benefit by doing so. Also rejected is respondents' suggestion that the attorney-client relationship be treated as a sort of business partnership or joint venture for tax purposes. In fact, that relationship is a quintessential principal-agent relationship, for the client retains ultimate dominion and control over the underlying claim. The attorney can make tactical decisions without consulting the client, but the client still must determine whether to settle or **828 proceed to judgment and make, as well, other critical decisions. The attorney is an agent who is duty bound to act in the principal's interests, and so it is appropriate to treat the full recovery amount as income to the principal. This rule applies regardless of whether the attorney-client contract or state law confers any special rights or protections on the attorney, so long as such protections do not alter the relationship's fundamental principal-agent character. The Court declines to comment on other theories proposed by respondents and their *amici,* which were not advanced in earlier stages of the litigation or examined by the Courts of Appeals. Pp. 831-833.

(d) This Court need not address Banks' contention that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee-shifting provisions, such as those applicable in *428 his case brought under 42 U.S.C. §§ 1981, 1983, and 2000e *et seq.* He settled his case, and the fee paid to his attorney was calculated based solely on the contingent-fee contract. There was no court-ordered fee award or any indication in his contract with his attorney or the settlement that the contingent fee paid was in lieu of statutory fees that might otherwise have been recovered. Also, the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes. Pp. 833-834.

No. 03-892, 345 F.3d 373; No. 03-907, 340 F.3d 1074, reversed and remanded.

KENNEDY, J., delivered the opinion of the Court, in which all other Members joined, except REHNQUIST, C.J., who took no part in the decision of the cases.

Attorneys and Law Firms

Philip N. Jones, Counsel of Record, for Respondent Banaitis in 03-907, Duffy Kekel, LLP, Portland, OR, Russell R. Young, Counsel of Record, for Respondent Banks in 03-892, Mayer, Brown, Rowe & Maw, LLP, Chicago, IL, Joint Supplemental Brief for Respondents.

Paul D. Clement, Acting Solicitor General, Counsel of Record, Department of Justice, Washington, D.C., for the Petitioner.

Robert G. Wilson, James R. Carty, Colkin, Collins & Ginsburg, APC, Los Angeles, CA, Glenn P. Schwartz, The John Marshall Law School, Chicago, IL, Russell R. Young, Counsel of Record, Roger J. Jones, Mayer, Brown, Rowe & Maw LLP, Chicago, IL, William J. Wise, Querrey & Harrow, Ltd., Chicago, IL, Brief for the Respondent.

Theodore B. Olson, Solicitor General, Counsel of Record, Eileen J. O'Connor, Assistant Attorney General, Thomas G. Hungar, Deputy Solicitor General, David B. Salmons, Assistant to the Solicitor General, Richard Farber, Kenneth W. Rosenberg, Attorneys, Department of Justice, Washington, D.C., for Petitioner.

Opinion

Justice KENNEDY delivered the opinion of the Court.

*429 The question in these consolidated cases is whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent-fee agreement is income to the plaintiff under the Internal Revenue Code, 26 U.S.C. § 1 *et seq.* (2000 ed. and Supp. I). The issue divides the courts of appeals. In one of the instant cases, *Banks v. Commissioner,* 345 F.3d 373 (2003), the Court of Appeals for the Sixth Circuit held the contingent-fee portion of a litigation recovery is not included ****829** in the plaintiff's gross income. The Courts of Appeals for the Fifth and Eleventh Circuits also adhere to this view, relying on the holding, over Judge Wisdom's dissent, in *Cotnam v. Commissioner,* 263 F.2d 119, 125-126 (C.A.5 1959). *Srivastava v. Commissioner,* 220 F.3d 353, 363-365 (C.A.5 2000); *Foster v. United States,* 249 F.3d 1275, 1279-1280 (C.A.11 2001). In the other case under review, *Banaitis v. Commissioner,* 340 F.3d 1074 (2003), the Court of Appeals for the Ninth Circuit held that the portion of the recovery paid to the attorney as a contingent fee is excluded from the plaintiff's gross income if state law gives the plaintiff's attorney a special property interest in the fee, but not otherwise. Six Courts of Appeals have held the entire litigation recovery, including the portion paid to an attorney as a contingent fee, is income to the plaintiff. Some of these Courts of Appeals discuss state law, but little of their analysis appears to turn on this factor. *Raymond v. United States,* 355 F.3d 107, 113-116 (C.A.2 2004); *Kenseth v. Commissioner,* 259 F.3d 881, 883-884 (C.A.7 2001); *Baylin v. United States,* 43 F.3d 1451, 1454-1455 (C.A.Fed.1995). ***430** Other Courts of Appeals have been explicit that the fee portion of the recovery is always income to the plaintiff regardless of the nuances of state law. *O'Brien v. Commissioner,* 38 T.C. 707, 712, 1962 WL 1147 (1962), aff'd, 319 F.2d 532 (C.A.3 1963) *(per curiam); Young v. Commissioner,* 240 F.3d 369, 377-379 (C.A.4 2001); *Hukkanen-Campbell v. Commissioner,* 274 F.3d 1312, 1313-1314 (C.A.10 2001). We granted certiorari to resolve the conflict. 541 U.S. 958, 124 S.Ct. 1712, 1713, 158 L.Ed.2d 398 (2004).

[1] We hold that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. We reverse the decisions of the Courts of Appeals for the Sixth and Ninth Circuits.

I

A. *Commissioner v. Banks*

In 1986, respondent John W. Banks, II, was fired from his job as an educational consultant with the California Department of Education. He retained an attorney on a contingent-fee basis and filed a civil suit against the employer in a United States District Court. The complaint alleged employment discrimination in violation of 42 U.S.C. §§ 1981 and 1983, Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e *et seq.,* and Cal. Govt.Code Ann. § 12965 (West 1986). The original complaint asserted various additional claims under state law, but Banks later abandoned these. After trial commenced in 1990, the parties settled for $464,000. Banks paid $150,000 of this amount to his attorney pursuant to the fee agreement.

Banks did not include any of the $464,000 in settlement proceeds as gross income in his 1990 federal income tax return. In 1997 the Commissioner of Internal Revenue issued Banks a notice of deficiency for the 1990 tax year. The Tax Court upheld the Commissioner's determination, finding that all the settlement proceeds, including the $150,000 Banks had paid to his attorney, must be included in Banks' gross income.

***431** The Court of Appeals for the Sixth Circuit reversed in part. 345 F.3d 373 (2003). It agreed the net amount received by Banks was included in gross income but not the amount paid to the attorney. Relying on its prior decision in *Estate of Clarks ex rel. Brisco-Whitter v. United States,* 202 F.3d 854 (2000), the court held the contingent-fee agreement was not an anticipatory assignment of Banks' income because the litigation recovery was not already earned, vested, or even relatively ****830** certain to be paid when the contingent-fee contract was made. A contingent-fee arrangement, the court reasoned, is more like a partial assignment of income-producing property than an assignment of income. The attorney is not the mere beneficiary of the client's largess, but rather earns his fee through skill and diligence. 345 F.3d, at 384-385 (quoting *Estate of Clarks, supra,* at 857-858). This reasoning, the court held, applies whether or not state law grants the attorney any special property interest (*e.g.,* a superior lien) in part of the judgment or settlement proceeds.

B. *Commissioner v. Banaitis*

After leaving his job as a vice president and loan officer at the Bank of California in 1987, Sigitas J. Banaitis retained an attorney on a contingent-fee basis and brought suit in Oregon state court against the Bank of California and its successor in ownership, the

Mitsubishi Bank. The complaint alleged that Mitsubishi Bank willfully interfered with Banaitis' employment contract, and that the Bank of California attempted to induce Banaitis to breach his fiduciary duties to customers and discharged him when he refused. The jury awarded Banaitis compensatory and punitive damages. After resolution of all appeals and post-trial motions, the parties settled. The defendants paid $4,864,547 to Banaitis; and, following the formula set forth in the contingent-fee contract, the defendants paid an additional $3,864,012 directly to Banaitis' attorney.

***432** Banaitis did not include the amount paid to his attorney in gross income on his federal income tax return, and the Commissioner issued a notice of deficiency. The Tax Court upheld the Commissioner's determination, but the Court of Appeals for the Ninth Circuit reversed. 340 F.3d 1074 (2003). In contrast to the Court of Appeals for the Sixth Circuit, the *Banaitis* court viewed state law as pivotal. Where state law confers on the attorney no special property rights in his fee, the court said, the whole amount of the judgment or settlement ordinarily is included in the plaintiff's gross income. *Id.,* at 1081. Oregon state law, however, like the law of some other States, grants attorneys a superior lien in the contingent-fee portion of any recovery. As a result, the court held, contingent-fee agreements under Oregon law operate not as an anticipatory assignment of the client's income but as a partial transfer to the attorney of some of the client's property in the lawsuit.

II

To clarify why the issue here is of any consequence for tax purposes, two preliminary observations are useful. The first concerns the general issue of deductibility. For the tax years in question the legal expenses in these cases could have been taken as miscellaneous itemized deductions subject to the ordinary requirements, 26 U.S.C. §§ 67-68 (2000 ed. and Supp. I), but doing so would have been of no help to respondents because of the operation of the Alternative Minimum Tax (AMT). For noncorporate individual taxpayers, the AMT establishes a tax liability floor equal to 26 percent of the taxpayer's "alternative minimum taxable income" (minus specified exemptions) up to $175,000, plus 28 percent of alternative minimum taxable income over $175,000. §§ 55(a), (b) (2000 ed.). Alternative minimum taxable income, unlike ordinary gross income, does not allow any miscellaneous itemized deductions. § 56(b)(1)(A)(i).

[2] ***433** Second, after these cases arose Congress enacted the American Jobs Creation Act of 2004, 118 Stat. 1418. Section 703 of the Act amended the Code by adding § 62(a)(19). *Id.,* at 1546. The amendment allows a taxpayer, in computing adjusted gross income, to deduct "attorney fees and court costs paid by, or on behalf ****831** of, the taxpayer in connection with any action involving a claim of unlawful discrimination." *Ibid.* The Act defines "unlawful discrimination" to include a number of specific federal statutes, §§ 62(e)(1) to (16), any federal whistle-blower statute, § 62(e)(17), and any federal, state, or local law "providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship ... or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law," § 62(e)(18). *Id.,* at 1547-1548. These deductions are permissible even when the AMT applies. Had the Act been in force for the transactions now under review, these cases likely would not have arisen. The Act is not retroactive, however, so while it may cover future taxpayers in respondents' position, it does not pertain here.

III

[3] The Internal Revenue Code defines "gross income" for federal tax purposes as "all income from whatever source derived." 26 U.S.C. § 61(a). The definition extends broadly to all economic gains not otherwise exempted. *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 429-430, 75 S.Ct. 473, 99 L.Ed. 483 (1955); *Commissioner v. Jacobson,* 336 U.S. 28, 49, 69 S.Ct. 358, 93 L.Ed. 477 (1949). A taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. *Lucas v. Earl,* 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930); *Commissioner v. Sunnen,* 333 U.S. 591, 604, 68 S.Ct. 715, 92 L.Ed. 898 (1948); *Helvering v. Horst,* 311 U.S. 112, 116-117, 61 S.Ct. 144, 85 L.Ed. 75 (1940). The rationale for the so-called anticipatory assignment of income doctrine is the principle that gains should be taxed "to those who earned them," ***434** *Lucas, supra,* at 114, 50 S.Ct. 241, a maxim we have called "the first principle of income taxation," *Commissioner* *v. Culbertson,* 337 U.S. 733, 739-740, 69 S.Ct. 1210, 93 L.Ed. 1659 (1949). The anticipatory assignment doctrine is meant to prevent taxpayers from avoiding taxation through "arrangements and contracts however skillfully devised to prevent [income] when paid from vesting even for a second in the man who earned it." *Lucas,* 281 U.S., at 115, 50 S.Ct. 241. The rule is preventative and motivated by administrative as well as substantive concerns, so we do not inquire whether any particular assignment has a discernible tax avoidance purpose. As *Lucas* explained, "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Ibid.*

Respondents argue that the anticipatory assignment doctrine is a judge-made antifraud rule with no relevance to contingent-fee contracts of the sort at issue here. The Commissioner maintains that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. We agree with the Commissioner.

In an ordinary case attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. *Glenshaw Glass Co., supra,* at 431, 75 S.Ct. 473; see also *Commissioner v. Indianapolis Power & Light Co.,* 493 U.S. 203, 209, 110 S.Ct. 589, 107 L.Ed.2d 591 (1990); *Commissioner v. First Security Bank of Utah, N. A.,* 405 U.S. 394, 403, 92 S.Ct. 1085, 31 L.Ed.2d 318 (1972). In the context of anticipatory assignments, however, the assignor often does not have dominion over the income at the moment of receipt. In that instance the question becomes whether the assignor **832 retains dominion over the income-generating asset, because the taxpayer "who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Horst, supra,* at 116-117, 61 S.Ct. 144. See also *Lucas,* *435 *supra,* at 114-115, 50 S.Ct. 241; *Helvering v. Eubank,* 311 U.S. 122, 124-125, 61 S.Ct. 149, 85 L.Ed. 81 (1940); *Sunnen, supra,* at 604, 68 S.Ct. 715. Looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits.

In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. We do not understand respondents to argue otherwise. Rather, respondents advance two counterarguments. First, they say that, in contrast to the bond coupons assigned in *Horst,* the value of a legal claim is speculative at the moment of assignment, and may be worth nothing at all. Second, respondents insist that the claimant's legal injury is not the only source of the ultimate recovery. The attorney, according to respondents, also contributes income-generating assets-effort and expertise-without which the claimant likely could not prevail. On these premises respondents urge us to treat a contingent-fee agreement as establishing, for tax purposes, something like a joint venture or partnership in which the client and attorney combine their respective assets-the client's claim and the attorney's skill-and apportion any resulting profits.

[4] We reject respondents' arguments. Though the value of the plaintiff's claim may be speculative at the moment the fee agreement is signed, the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance. *Lucas, supra; United States v. Basye,* 410 U.S. 441, 445, 450-452, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973). Though *Horst* involved an anticipatory assignment of a predetermined sum to be paid on a specific date, the holding in that case did not depend on ascertaining a liquidated amount at the time of assignment. In each of the cases before us, as in *Horst,* the taxpayer retained control over the income-generating asset, diverted some of the income produced to another party, and realized a benefit by doing so. As Judge *436 Wesley correctly concluded in a recent case, the rationale of *Horst* applies fully to a contingent-fee contract. *Raymond v. United States,* 355 F.3d, at 115-116. That the amount of income the asset would produce was uncertain at the moment of assignment is of no consequence.

We further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes. The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship. Restatement (Second) of Agency § 1, Comment *e* (1957) (hereinafter Restatement); ABA Model

Rules of Professional Conduct Rule 1.3, and Comment 1; Rule 1.7, and Comment 1 (2002). The client may rely on the attorney's expertise and special skills to achieve a result the client could not achieve alone. That, however, is true of most principal-agent relationships, and it does not alter the fact that the client retains ultimate dominion and control over the underlying claim. The control is evident when it is noted that, although the **833 attorney can make tactical decisions without consulting the client, the plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions. Even where the attorney exercises independent judgment without supervision by, or consultation with, the client, the attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party. Restatement §§ 13, 39, 387.

The attorney is an agent who is dutybound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal. In this respect Judge Posner's observation is apt: "[T]he contingent-fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable." *437 *Kenseth,* 259 F.3d, at 883. In both cases a principal relies on an agent to realize an economic gain, and the gain realized by the agent's efforts is income to the principal. The portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income.

This rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship. Cf. Restatement § 13, Comment *b,* and § 14G, Comment *a* (an agency relationship is created where a principal assigns a chose in action to an assignee for collection and grants the assignee a security interest in the claim against the assignor's debtor in order to compensate the assignee for his collection efforts). State laws vary with respect to the strength of an attorney's security interest in a contingent fee and the remedies available to an attorney should the client discharge or attempt to defraud the attorney. No state laws of which we are aware, however, even those that purport to give attorneys an "ownership" interest in their fees, *e.g.,* 340 F.3d, at 1082-1083 (discussing Oregon law); *Cotnam,* 263 F.2d, at 125 (discussing Alabama law), convert the attorney from an agent to a partner.

Respondents and their *amici* propose other theories to exclude fees from income or permit deductibility. These suggestions include: (1) The contingent-fee agreement establishes a Subchapter K partnership under 26 U.S.C. §§ 702, 704, and 761, Brief for Respondent in No. 03-907, pp. 5-21; (2) litigation recoveries are proceeds from disposition of property, so the attorney's fee should be subtracted as a capital expense pursuant to §§ 1001, 1012, and 1016, Brief for Association of Trial Lawyers of America as *Amicus Curiae* 23-28, Brief for Charles Davenport as *Amicus Curiae* 3-13; and (3) the fees are deductible reimbursed employee business expenses under § 62(a)(2)(A) (2000 ed. and Supp. I), Brief for *438 Stephen B. Cohen as *Amicus Curiae.* These arguments, it appears, are being presented for the first time to this Court. We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories. In addition, we do not reach the instance where a relator pursues a claim on behalf of the United States. Brief for Taxpayers Against Fraud Education Fund as *Amicus Curiae* 10-20.

IV

The foregoing suffices to dispose of Banaitis' case. Banks' case, however, involves a further consideration. Banks **834 brought his claims under federal statutes that authorize fee awards to prevailing plaintiffs' attorneys. He contends that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee-shifting provisions. See *Venegas v. Mitchell,* 495 U.S. 82, 86, 110 S.Ct. 1679, 109 L.Ed.2d 74 (1990) (observing that statutory fees enable "plaintiffs to employ reasonably competent lawyers without cost to themselves if they prevail"). In the federal system statutory fees are typically awarded by the court under the lodestar approach, *Hensley v. Eckerhart,* 461 U.S. 424, 433, 103 S.Ct. 1933, 76 L.Ed.2d 40 (1983), and the plaintiff usually has little control over the amount awarded. Sometimes, as when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs' recoveries, or when for other reasons damages are substantially less than attorney's fees, court-awarded attorney's fees can exceed a plaintiff's monetary recovery. See, *e.g., Riverside v. Rivera,* 477 U.S. 561, 564-565, 106 S.Ct. 2686, 91 L.Ed.2d 466 (1986) (compensatory and punitive damages of $33,350; attorney's fee award of $245,456.25). Treating the fee award as income to the plaintiff in such cases, it is argued, can lead to the perverse result that the plaintiff loses money by winning the suit. Furthermore, it is urged that treating statutory fee awards as income to plaintiffs would ***439** undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general.

We need not address these claims. After Banks settled his case, the fee paid to his attorney was calculated solely on the basis of the private contingent-fee contract. There was no court-ordered fee award, nor was there any indication in Banks' contract with his attorney, or in the settlement agreement with the defendant, that the contingent fee paid to Banks' attorney was in lieu of statutory fees Banks might otherwise have been entitled to recover. Also, the amendment added by the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.

* * *

For the reasons stated, the judgments of the Courts of Appeals for the Sixth and Ninth Circuits are reversed, and the cases are remanded for further proceedings consistent with this opinion.

It is so ordered.

THE CHIEF JUSTICE took no part in the decision of these cases.

All Citations

543 U.S. 426, 2005-15 I.R.B. 850, 125 S.Ct. 826, 160 L.Ed.2d 859, 94 Fair Empl.Prac.Cas. (BNA) 1793, 95 A.F.T.R.2d 2005-659, 73 USLW 4117, 2005-1 USTC P 50,155, 2005-1 C.B. 850, 05 Cal. Daily Op. Serv. 644, 2005 Daily Journal D.A.R. 845, 18 Fla. L. Weekly Fed. S 106

Footnotes

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

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75 S.Ct. 473
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, Petitioner,
v.
GLENSHAW GLASS COMPANY and William Goldman Theatres, Inc.

No. 199.
|
Argued Feb. 28, 1955.
|
Decided March 28, 1955.
|
Rehearing Denied May 9, 1955.

See 349 U.S. 925, 75 S.Ct. 657.

Synopsis

Proceedings on taxpayers' petitions to challenge Commissioner of Internal Revenue's determination of income tax deficiencies. The Tax Court, 18 T.C. 860 and 19 T.C. 637, rendered decisions in favor of taxpayers, and Commissioner appealed. The United States Court of Appeals for the Third Circuit, 211 F.2d 928, affirmed the decisions, and the Commissioner obtained certiorari. The Supreme Court, Mr. Chief Justice Warren, held that money received by settlement, as exemplary damages for fraud and antitrust violations and as the punitive two-thirds portion of a treble damage antitrust recovery was taxable.

Reversed.

Mr. Justice Douglas dissented.

Attorneys and Law Firms

*426 **474 Solicitor General, Simon E. Sobeloff, Washington, D.C., for petitioner.

Mr. *427 Max Swiren, Chicago, Ill., for respondent Glenshaw Glass Co.

Mr. Samuel H. Levy, Philadelphia, Pa., for respondent Wm. Goldman Theatres, Inc.

Opinion

Mr. Chief Justice WARREN delivered the opinion of the Court.

[1] This litigation involves two cases with independent factual backgrounds yet presenting the identical issue. The two cases were consolidated for argument before the Court of Appeals for the Third Circuit and were heard en banc. The common question is whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery **475 must be reported by a taxpayer as gross income under s 22(a) of the Internal Revenue Code of 1939.[1] In a single opinion, 211 F.2d 928, the Court of Appeals affirmed the Tax Court's separate rulings in favor of the taxpayers. 18 T.C. 860; 19 T.C. 637. Because of the frequent recurrence of the question and differing interpretations by the lower courts of this Court's decisions bearing upon the problem, we granted the Commissioner of Internal Revenue's ensuing petition for certiorari. 348 U.S. 813, 75 S.Ct. 50.

The facts of the cases were largely stipulated and are not in dispute. So far as pertinent they are as follows:

Commissioner v. Glenshaw Glass Co.-- The Glenshaw Glass Company, a Pennsylvania corporation, manufactures glass bottles and containers. It was engaged in protracted litigation with the Hartford-Empire Company, which manufactures machinery of a character used by Glenshaw. Among the claims advanced by Glenshaw *428 were demands for exemplary damages for fraud[2] and treble damages for injury to its business by reason of Hartford's violation of the federal antitrust laws.[3] In December, 1947, the parties concluded a settlement of all pending litigation, by which Hartford paid Glenshaw approximately $800,000. Through a method of allocation which was approved by the Tax Court, 18 T.C. 860, 870–872, and which is no longer in issue, it was ultimately determined that, of the total settlement, $324,529.94 represented payment of punitive damages for fraud and antitrust violations. Glenshaw did not report this portion of the settlement as income for the tax year involved. The Commissioner determined a deficiency claiming as taxable the entire sum less only deductible legal fees. As previously noted, the Tax Court and the Court of Appeals upheld the taxpayer.

Commissioner v. William Goldman Theatres, Inc.—William Goldman Theatres, Inc., a Delaware corporation operating motion picture houses in Pennsylvania, sued Loew's, Inc., alleging a violation of the federal antitrust laws and seeking treble damages. After a holding that a violation had occurred, William Goldman Theatres, Inc., v. Loew's Inc., 3 Cir., 150 F.2d 738, the case was remanded to the trial court for a determination of damages. It was found that Goldman had suffered a loss of profits equal to $125,000 and was entitled to treble damages in the sum of $375,000. William Goldman Theatres, Inc., v. Loew's, Inc., D.C., 69 F.Supp. 103, affirmed 3 Cir., 164 F.2d 1021, certiorari denied 334 U.S. 811, 68 S.Ct. 1016, 92 L.Ed. 1742. Goldman reported only $125,000 of the recovery as gross income and claimed that the $250,000 *429 balance constituted punitive damages and as such was not taxable. The Tax Court agreed, 19 T.C. 637, and the Court of Appeals, hearing this with the Glenshaw case, affirmed. 211 F.2d 928.

[2] It is conceded by the respondents that there is no constitutional barrier to the imposition of a tax on punitive damages. Our question is one of statutory construction: are these payments comprehended by s 22(a)?

The sweeping scope of the controverted statute is readily apparent:

's 22. Gross income

'(a) General definition. 'Gross income' includes gains, profits, and **476 income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *' (Emphasis added.)[4]

[3] This Court has frequently stated that this language was used by Congress to exert in this field 'the full measure of its taxing power.' Helvering v. Clifford, 309 U.S. 331, 334, 60 S.Ct. 554, 556, 84 L.Ed. 788; Helvering v. Midland Mutual Life Ins. Co., 300 U.S. 216, 223, 57 S.Ct. 423, 425, 81 L.Ed. 612; Douglas v. Willcuts, 296 U.S. 1, 9, 56 S.Ct. 59, 62, 80 L.Ed. 3; Irwin v. Gavit, 268 U.S. 161, 166, 45 S.Ct. 475, 69 L.Ed. 897. Respondents contend that punitive damages, characterized as 'windfalls' flowing from the culpable conduct of third parties, are not within the scope of the section. But Congress applied no limitations as to the source of taxable receipts, nor restrictive *430 labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. Commissioner v. Jacobson, 336 U.S. 28, 49, 69 S.Ct. 358, 369, 93 L.Ed. 477; Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87—91, 55 S.Ct. 50, 51—53, 79 L.Ed. 211. Thus, the fortuitous gain accruing to a lessor by reason of the forfeiture of a lessee's improvements on the rented property was taxed in Helvering v. Bruun, 309 U.S. 461, 60 S.Ct. 631, 84 L.Ed. 864. Cf. Robertson v. United States, 343 U.S. 711, 72 S.Ct. 994, 96 L.Ed. 1237; Rutkin v. United States, 343 U.S. 130, 72 S.Ct. 571, 96 L.Ed. 833; United States v. Kirby Lumber Co., 284 U.S. 1, 52 S.Ct. 4, 76 L.Ed. 131. Such decisions demonstrate that we cannot but ascribe content to the catchall provision of s 22(a), 'gains or profits and income derived from any source whatever.' The importance of that phrase has been to frequently recognized since its first appearance in the Revenue Act of 1913[5] to say now that it adds nothing to the meaning of 'gross income.'

Nor can we accept respondents' contention that a narrower reading of s 22(a) is required by the Court's characterization of income in Eisner v. Macomber, 252 U.S. 189, 207, 40 S.Ct. 189, 193, 64 L.Ed. 521, as "the gain derived from capital, from labor, or from both combined."[6] The Court was there endeavoring to determine whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed 'only the form, not the essence,' of *431 his capital investment. Id., 252 U.S. at page 210, 40 S.Ct. at page 194. It was held that the taxpayer had 'received nothing out of the company's assets for his separate use and benefit.' Id., 252 U.S. at page 211, 40 S.Ct. at page 194. The distribution, therefore, was held not a taxable event. In that context—distinguishing gain from capital **477—the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions. Helvering v. Bruun, supra, 309 U.S. at pages 468—469, 60 S.Ct. at page 634; United States v. Kirby Lumber Co., supra, 284 U.S. at page 3, 52 S.Ct. 4.

[4] Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers

have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. Respondents concede, as they must, that the recoveries are taxable to the extent that they compensate for damages actually incurred. It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments.

[5] [6] [7] [8] [9] [10] It is urged that re-enactment of s 22(a) without change since the Board of Tax Appeals held punitive damages nontaxable in Highland Farms Corp., 42 B.T.A. 1314, indicates congressional satisfaction with that holding. Re-enactment—particularly without the slightest affirmative indication that Congress ever had the Highland Farms decision before it—is an unreliable indicium at best. Helvering v. Wilshire Oil Co., 308 U.S. 90, 100—101, 60 S.Ct. 18, 24, 84 L.Ed. 101; Koshland v. Helvering, 298 U.S. 441, 447, 56 S.Ct. 767, 770, 80 L.Ed. 1268. Moreover, the Commissioner promptly published his non-acquiescence in this portion of the Highland Farms holding [7] and has, ***432** before and since, consistently maintained the position that these receipts are taxable. [8] It therefore cannot be said with certitude that Congress intended to carve an exception out of s 22(a)'s pervasive coverage. Nor does the 1954 Code's [9] legislative history, with its reiteration of the proposition that statutory gross income is 'all-inclusive,' [10] give support to respondents' position. The definition of gross income has been simplied, but no effect upon its present broad scope was intended. [11] Certainly punitive damages cannot reasonably be classified as gifts, cf. Commissioner v. Jacobson, 336 U.S. 28, 47—52, 69 S.Ct. 358, 368—370, 93 L.Ed. 477, nor do they come under any other exemption provision in the Code. We would do violence to the plain meaning of the statute and restrict a clear legislative attempt to ***433** bring the ****478** taxing power to bear upon all receipts constitutionally taxable were we to say that the payments in question here are not gross income. See Helvering v. Midland Mutual Life Ins. Co., supra, 300 U.S. at page 223, 57 S.Ct. at page 425, 81 L.Ed. 612.

Reversed.

Mr. Justice DOUGLAS dissents.

Mr. Justice HARLAN took no part in the consideration or decision of this case.

All Citations

348 U.S. 426, 75 S.Ct. 473, 99 L.Ed. 483, 55-1 USTC P 9308, 47 A.F.T.R. 162, 1955-1 C.B. 207

Footnotes

1 53 Stat. 9, 53 Stat. 574, 26 U.S.C. s 22(a), 26 U.S.C.A. s 22(a).

2 For the bases of Glenshaw's claim for damages from fraud, see Shawkee Manufacturing Co. v. Hartford-Empire Co., 322 U.S. 271, 64 S.Ct. 1014, 88 L.Ed. 1269; Hazel-Atlas Glass Co. v. Hartford-Empire Co., 322 U.S. 238, 64 S.Ct. 997, 88 L.Ed. 1250.

3 See Hartford-Empire Co. v. United States, 323 U.S. 386, 65 S.Ct. 373, 89 L.Ed. 322; Id., 324 U.S. 570, 65 S.Ct. 815, 89 L.Ed. 1198.

4 See note 1, supra.

5 38 Stat. 114, 167.

6 The phrase was derived from Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415, 34 S.Ct. 136, 140, 58 L.Ed. 285, and Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185, 38 S.Ct. 467, 469, 62 L.Ed. 1054, two cases construing the Revenue Act of 1909, 36 Stat. 11, 112. Both taxpayers were 'wasting asset' corporations, one being engaged in mining, the other in lumbering operations. The definition was applied by the Court to demonstrate a distinction between a return on capital and 'a mere conversion of capital assets.' Doyle v. Mitchell Bros. Co., supra, 247 U.S. at page 184, 38 S.Ct. at page 469. The question raised by the instant case is clearly distinguishable.

7 1941—1 Cum.Bull. 16.

8 The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property. See 2 Cum.Bull. 71; I—1 Cum.Bull. 92, 93; VII—2 Cum.Bull. 123; 1954—1 Cum.Bull. 179, 180. Damages for personal injury

are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.

9 68A Stat. 3 et seq. Section 61(a) of the Internal Revenue Code of 1954, 68A Stat. 17, 26 U.S.C.A., is the successor to s 22(a) of the 1939 Code.

10 H.R.Rep.No.1337, 83d Cong., 2d Sess. A18; S.Rep.No.1622, 83d Cong., 2d Sess. 168.

11 In discussing s 61(a) of the 1954 Code, the House Report states:

'This section corresponds to section 22(a) of the 1939 Code. While the language in existing section 22(a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61(a) is as broad in scope as section 22(a).

'Section 61(a) provides that gross income includes 'all income from whatever source derived.' This definition is based upon the 16th Amendment and the word 'income' is used in its constitutional sense.' H.R.Rep.No.1337, supra, note 10, at A18.

A virtually identical statement appears in S.Rep.No.1622, supra, note 10, at 168.

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513 F.2d 224
United States Court of Appeals,
Seventh Circuit.

Charles N. HAVERLY and Ruth L. Haverly, Plaintiffs-Appellees,
v.
UNITED STATES of America, Defendant-Appellant.

No. 74-1457.
|
Argued Jan. 10, 1975.
|
Decided March 20, 1975.
|
Rehearing En Banc Denied May 5, 1975.

Synopsis

After paying amount of income tax deficiency assessed by the Internal Revenue Service, taxpayer and his wife filed a claim for refund and subsequently instituted suit to recover that amount. The United States District Court for the Northern District of Illinois, Eastern Division, Hubert L. Will, J., 374 F.Supp. 1041, entered judgment in favor of taxpayer, and the United States appealed. The Court of Appeals, Hastings, Senior Circuit Judge, held that the value of unsolicited sample textbooks sent by publishers to the principal of a public elementary school, which he subsequently donated to the school's library and for which he claimed a charitable deduction, constituted gross income to the principal.

Reversed.

Attorneys and Law Firms

***225** Scott P. Crampton, Asst. Atty. Gen., Jonathan S. Cohen, Atty., Tax Div., Dept. of Justice, Washington, D. C., Hon. James R. Thompson, U. S. Atty., Gary L. Starkman, Asst. U. S. Atty., Chicago, Ill., for defendant-appellant.

Ronald S. Supena, Chicago, Ill., for plaintiffs-appellees.

Before HASTINGS, Senior Circuit Judge, SWYGERT and CUMMINGS, Circuit Judges.

Opinion

HASTINGS, Senior Circuit Judge.

This case presents for resolution a single question of law which is of first impression: whether the value of unsolicited sample textbooks sent by publishers to a principal of a public elementary school, which he subsequently donated to the school's library and for which he claimed a charitable deduction, constitutes gross income to the principal within the meaning of Section 61 of the Internal Revenue Code of 1954, 26 U.S.C. s 61.

This action was brought by the plaintiffs in the district court for recovery of income taxes paid to the United States. Jurisdiction was based on 28 U.S.C. s 1346(a)(1). The parties stipulated to the relevant facts.

During the years 1967 and 1968 Charles N. Haverly [1] was the principal of the Alice L. Barnard Elementary School in Chicago, Illinois. In each of these years publishers sent to the taxpayer unsolicited sample copies of textbooks which had a total fair market value at the time of receipt of $400. The samples were given to taxpayer for his personal retention or for whatever disposition he wished to make. The samples were provided, in the hope of receiving favorable consideration, to give taxpayer an opportunity to examine the books and determine whether they were suitable for the instructional unit for which he was responsible. The publishers did not intend that the books serve as compensation.

In 1968 taxpayer donated the books to the Alice L. Barnard Elementary School Library. The parties agreed that the donation entitled the taxpayer to a charitable deduction under 26 U.S.C. s 170, in the amount of $400, the value of the books at the time of the contribution. [2]

The parties further stipulated that the textbooks received from the publishers did not constitute gifts within the meaning of 26 U.S.C. s 102 since their transfer to the taxpayer did not proceed from a detached and disinterested generosity nor out of affection, respect, admiration, charity or like impulses.

Taxpayer's report of his 1968 income did not include the value of the textbooks received, but it did include a charitable deduction for the value of the books donated to the school library. The Internal Revenue Service assessed a deficiency against the taxpayer representing income taxes on the value of the textbooks ***226** received. Taxpayer paid the amount of the deficiency, filed a claim for refund and subsequently instituted this action to recover that amount.[3]

The amount of income, if any, and the time of its receipt are not issues here since the parties stipulated that if the contested issue of law was decided in the taxpayer's favor, his taxable income for 1968 as determined by the Internal Revenue Service would be reduced by $400.00.

Upon agreement of the parties, the case was submitted to the district court on the uncontested facts and briefs for decision without trial. The district court issued a memorandum opinion which held that receipt of the samples did not constitute income. Haverly v. United States, N.D.Ill., 374 F.Supp. 1041 (1974). The court subsequently ordered, in accordance with its decision, that plaintiffs recover from the United States the sum of $120.40 plus interest. The United States appeals from that judgment. We reverse.

Section 61(a) of Title 26 of the United States Code provides: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:" The section thereafter enumerates fifteen items none of which, the government concedes, encompass the receipt of sample textbooks. The taxpayer concedes that receipt of the books does not fall within any of the specific exclusions from gross income set out in Sections 101 through 124 of Title 26. The only question remaining is whether the value of the textbooks received is included within "all income from whatever source derived."

The Supreme Court has frequently reiterated that it was the intention of Congress "to use the full measure of its taxing power" and "to tax all gains except those specifically exempted." James v. United States, 366 U.S. 213, 218-219, 81 S.Ct. 1052, 1054-1055, 6 L.Ed.2d 246 (1961). The Supreme Court has also held that the language of Section 61(a) encompasses all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Id. at 219, 81 S.Ct. at 1055; Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426, 431, 75 S.Ct. 473, 99 L.Ed. 483 (1955).

There are no reported cases which have applied these definitions of income to the question of the receipt of unsolicited samples. The parties have cited to the court a number of cases applying income definitions to other fact situations. We have considered these cases, but we find them of no particular assistance in resolving the question before us. In view of the comprehensive conception of income embodied in the statutory language and the Supreme Court's interpretation of that language, we conclude that when the intent to exercise complete dominion over unsolicited samples is demonstrated by donating those samples to a charitable institution and taking a tax deduction therefor, the value of the samples received constitutes gross income.

The receipt of textbooks is unquestionably an "accession to wealth." Taxpayer recognized the value of the books when he donated them and took a $400 deduction therefor. Possession of the books increased the taxpayer's wealth. Taxpayer's receipt and possession of the books indicate that the income was "clearly realized." Taxpayer admitted that the books were given to him for his personal retention or whatever disposition he saw fit to make of them. Although the receipt of unsolicited samples may sometimes raise the question of whether the taxpayer manifested an intent to accept the property or exercised ***227** "complete dominion" over it, there is no question that this element is satisfied by the unequivocal act of taking a charitable deduction for donation of the property.

The district court recognized that the act of claiming a charitable deduction does manifest an intent to accept the property as one's own. It nevertheless declined to label receipt of the property as income because it considered such an act indistinguishable from other acts unrelated to the tax laws which also evidence an intent to accept property as one's own, such as a school principal donating his sample texts to the library without claiming a deduction. We need not resolve the question of the tax consequences of this and other hypothetical cases discussed by the district court and suggested by the taxpayer. To decide the case before us we need only hold, as we do, that when a tax deduction is taken for the donation of unsolicited samples the value of the samples received must be included in the taxpayer's gross income.

This conclusion is consistent with Revenue Ruling 70-498, 1970-2 Cum.Bull. 6, in which the Internal Revenue Service held that a newspaper's book reviewer must include in his gross income the value of unsolicited books received from publishers which are donated to a charitable organization and for which a charitable deduction is taken. This ruling was issued to supercede an earlier ruling, Rev.Rul. 70-330, 1970-1 Cum.Bull. 14, that mere retention of unsolicited books was sufficient to cause them to be gross income.[4]

The Internal Revenue Service has apparently made an administrative decision to be concerned with the taxation of unsolicited samples only when failure to tax those samples would provide taxpayers with double tax benefits. It is not for the courts to quarrel with an agency's rational allocation of its administrative resources.

In light of the foregoing, the judgment appealed from is reversed and the case is remanded to the district court with directions to enter judgment for the United States.

Reversed.

All Citations

513 F.2d 224, 35 A.F.T.R.2d 75-1082, 75-1 USTC P 9326

Footnotes

1 References to the taxpayer are to the husband alone. Ruth L. Haverly is a party to this appeal solely because she filed a joint income tax return with her husband for the taxable year 1968.

2 Since the tax year at issue in this litigation is 1968, the amount of the charitable deduction which could be taken was unaffected by 26 U.S.C. s 170(e) (1) which was added by the Tax Reform Act of 1969, Pub.L.No. 91-172, 83 Stat. 487.

3 Taxpayer originally sought a refund of $288.76 and sought to recover that amount in this action. This amount reflected taxpayer's contentions that the books were not income and that he was entitled to a charitable deduction for $430 worth of books which had been given directly to the school by the publishers. In proceedings in the district court, taxpayer conceded that he was not entitled to a deduction for the books which the publishers had sent to the school.

4 The district court considered Revenue Ruling 70-498 distinguishable from the facts of the instant case on the ground that, for the book reviewer, the books were the tools of his trade. The district court did not explain why "tools of the trade" should be a significant factor in determining what is income, but even if it were, textbooks would seem to be a tool of the trade of being a school principal. The facts here indicate that it was one of taxpayer's functions as a principal to review sample textbooks to determine their suitability for his students.

816 F.2d 493
United States Court of Appeals,
Ninth Circuit.

Cleo Beatrice BAXTER and Albert
N. Baxter, Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL
REVENUE SERVICE, Respondent-Appellee.

No. 86-7285.
|
Argued and Submitted March 9, 1987.
|
Decided May 6, 1987.

Synopsis
The Tax Court upheld Commissioner of Internal Revenue's assessment of deficiency in taxpayer's return, and taxpayers appealed. The Court of Appeals, Noonan, Circuit Judge, held that: (1) taxpayer did not constructively receive funds during tax year where he could not have received credit for check at bank before January 2 of following tax year; (2) taxpayer failed to prove that his dominant hope and interest in entering on wind energy enterprise was to make a profit; and (3) imposition of penalty for negligent or intentional disregard of rules and regulations was clearly erroneous.

Affirmed in part, reversed in part and remanded.

Attorneys and Law Firms

*494 Cleo B. Baxter and Albert N. Baxter, pro se.

Laurie Snyder, Washington, D.C., for respondent-appellee.

Petition for Review of a Decision of the United States Tax Court.

Before KOELSCH and NOONAN, Circuit Judges, and BRYAN *, District Judge.

Opinion

NOONAN, Circuit Judge:

Albert Nathaniel Baxter (Baxter) and his wife, Cleo Beatrice Baxter, appeal the decision of the Tax Court upholding the Commissioner of Internal Revenue's assessment of a deficiency in their 1978 tax return. We reverse in part and affirm in part.

The First Issue: The Constructive Receipt of Income

Baxter received in January 1979 a check for $13,095 from Peter J. Veith. The check was for commissions earned by Baxter in 1978. The check was dated December 30, 1978. The Tax Court held that Baxter had "constructively" received the $13,095 in 1978.

Although the notion of constructive receipt blends a factual determination of what actually happened and a legal assessment of its significance, we have held that a finding of constructive receipt is a finding of fact. *Bennett v. United States,* 293 F.2d 323, 326 (9th Cir.1961). As such, it can be set aside only if clearly erroneous. *Anderson v. City of Bessemer,* 470 U.S. 564, 575, 105 S.Ct. 1504, 1512, 84 L.Ed.2d 518 (1985). Clear error exists here.

The Tax Court properly put no weight on the fact that Veith reported the payment as a deduction in 1978 and the fact that Baxter originally reported the payment as 1978 income, only later correcting this report as mistaken. The Tax Court rested its finding on Baxter's statement at trial that he "could have" picked up the check on December 30. The Tax Court concluded, "Thus, by petitioner's own testimony, the check was available to him in 1978 if he wanted to pick it up."

Income, although not actually reduced to possession, is constructively received by a taxpayer "in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." Reg. § 1.451-2(a). But the law has been glossed so that although money has been credited to one's account or set apart for one it is not income if some barrier exists to actual possession. Thus dividend checks prepared by a corporation *495 on December 31, but not regularly available until the first business day of January, were held to be income in the taxable year beginning in January. The checks did not constitute payments "prior to their actual receipt." *Avery v. Commissioner*, 292 U.S. 210, 215, 54 S.Ct. 674, 676, 78 L.Ed. 1216 (1934).

[1] In *McEuen v. Commissioner*, 196 F.2d 127, 129-130 (5th Cir.1952), it was suggested that geography does not create a barrier, but the case actually depended on the taxpayer controlling the time of payment by agreement with the payor. No such agreement was shown here. In this case, Veith lived forty miles from Baxter. December 30, 1978 was a Saturday. Baxter's testimony referred to a hypothetical situation: he could have gotten into a car and driven to Veith's and collected the check. But the day (a non-business day, Saturday), the distance (an 80 mile round trip), and the futility of such an expedition (he could not have received credit for the check at a bank before January 2) were as effective a barrier to his asserting control over the check as was the corporate routine that constituted a barrier in *Avery*. The statute itself prescribes: "However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." The Tax Court erred in not recognizing the substantial restrictions preventing Baxter's exercise of control here.

The Second Issue: Baxter's Profit Motive

Baxter in late 1978 bought for $120,000 a wind turbine and generator from Alternative Energy Corporation of America (AECA) and leased a chemical cell to make bleach from electricity to be generated by the wind. The equipment he purchased was to be installed in Dalhart, Texas. Baxter, a resident of California, had seen a prototype. He paid $6,000 down on the turbine and undertook to pay the rest in monthly payments; the outstanding balance was secured by the equipment. He leased the cell for $5,500. On his 1978 return Baxter claimed a $9,043 deduction for the turbine, valued at $120,000; a $12,000 energy tax credit for the turbine; a $6,857 investment tax credit for the turbine and cell; and a $6,100 lease expense for the cell. The deductions and credits claimed were far in excess of his cash outlay.

The Commissioner disallowed the deductions and credits, and the Tax Court affirmed. The Tax Court found that the contract for the turbine was essentially a nonrecourse obligation, so that Baxter in effect had only his original investment of $11,500 at risk. Baxter made no further payments on the turbine or the cell. The Tax Court noted that Baxter did not check AECA's financial condition. The Tax Court disbelieved Baxter's assertion that he was interested in income for his retirement years rather than in tax benefits for 1978, in which his income was $72,000. The Tax Court concluded that Baxter did not have the primary intention to make a profit.

Baxter argues that the Tax Court finding is flawed. Contrary to what the Tax Court asserts, Baxter was "an expert in wind generation." At least he had two degrees in mechanical engineering and had spent 25 years as a professor or engineer in the field of energy. He asserts that he had enough experience to make an assessment of the risks and rewards and that he sought to make a profit. Windmills at the time were being encouraged by the government and as an energy source in the oil crisis looked like a desirable investment. Baxter took a prudent interest in the business and actually visited Dalhart in December 1979. That the venture was unsuccessful and that no bleach was produced were without his fault and contrary to his expectations.

[2] [3] [4] Although the question of Baxter's purpose is not free from doubt, we are constrained by a triple barrier. First, the burden of proof to show that the Commissioner's determination was incorrect falls on the taxpayer. *Welch v. Helvering*, 290 U.S. 111, 54 S.Ct. 8, 78 L.Ed. 212 (1933). Second, although the statute requires only that a transaction be "engaged in for profit," I.R.C. § 183(a), case law requires that the enterprise be entered "with the dominant ***496** hope and intent of realizing a profit." *Independent Electric Supply, Inc. v. Commissioner*, 781 F.2d 724, 726 (9th Cir.1986), quoting *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir.1963). Third, the Tax Court's finding of intent cannot be reversed unless clearly erroneous. *Anderson v. City of Bessemer, supra.* We are unable to find that the Tax Court clearly erred in holding that Baxter failed to prove that his dominant hope and interest in entering on the wind energy enterprise was to make a profit. Consequently Baxter is not entitled to the deductions and credits claimed.

The Third Issue: The Negligence Penalty

[5] [6] The Tax Court's affirmance of the Commissioner's imposition of a penalty for negligent or intentional disregard of rules and regulations is a factual finding reviewed for clear error. *Bryant v. Commissioner*,

790 F.2d 1463 (9th Cir.1986). The Tax Court upheld the penalty simply by reciting that "the facts of this case support a finding that the petitioners were negligent or intentionally disregarded the rules and regulations." We find this conclusory statement less than illuminating as a statement of fact and unsupported by substantial evidence. Baxter had a good case on constructive receipt and an arguable case on the deductions and credits. That the Commissioner ultimately prevailed on the second issue is proof neither of negligence nor intentional disregard of the Internal Revenue Code.

Affirmed as to the claimed credits and deductions. *Reversed* as to the constructive receipt of income and the penalty for negligence and *Remanded* with instructions to enter judgment accordingly.

All Citations

816 F.2d 493, 59 A.F.T.R.2d 87-1068, 87-1 USTC P 9315

Footnotes

* Honorable Robert J. Bryan, United States District Judge for the Western District of Washington, sitting by designation.

End of Document

47 T.C. 428
Tax Court of the United States.

PAUL V. HORNUNG, PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 3740-64.
|
Filed January 27, 1967.

Attorneys and Law Firms

*429 Michael J. Clare, for the petitioner.

Sanford S. Neuman and S. Earl Heilman, for the respondent.

Synopsis

1. Held, the value of a Corvette automobile which was awarded to petitioner for being named the outstanding player in the 1961 National Football League championship game constituted gross income under sec. 74, I.R.C. 1954, in the year of receipt, 1962.

2. Held, further, the value of the free use of Thunderbird automobiles furnished to the petitioner by the Ford Motor Co. was not received as the result of a tax-exempt gift; and, under the particular facts of the case, an economic benefit was realized which constituted gross income. Petitioner has failed to carry his burden of proof that respondent's determination was erroneous.

3. Held, further, petitioner's gross income for 1962 should not include the value of a fur stole which was received by petitioner's mother from his employer in 1961.

Opinion

HOYT, Judge:

Respondent determined an income tax deficiency against petitioner in the amount of $3,163.76 for the taxable year 1962. Petitioner having conceded an issue relating to a travel expense deduction, the questions remaining for decision are:

(1) Whether the value of a 1962 Corvette automobile which was won by petitioner for his performance in a professional football game should be included in his gross income for the taxable year 1962.

(2) Whether the value of the use of 1962 Thunderbird automobiles furnished to the petitioner by the Ford Motor Co. should be included in his gross income for the taxable year 1962.

(3) Whether petitioner's gross income for 1962 should include the value of a fur stole received by petitioner's mother from his employer.

FINDINGS OF FACT

The stipulated facts are found accordingly and adopted as our findings.

Petitioner is a cash basis taxpayer residing in Louisville, Ky. For the taxable year 1962, petitioner filed his Federal individual income tax return (Form 1040) with the district director of internal revenue, Louisville, Ky. Petitioner is a well-known professional football player who was employed by the Green Bay Packers in 1962. Prior to becoming a professional, petitioner attended the University of Notre Dame and was an All-American quarterback on the university football team.

ISSUE 1. THE CORVETTE

Sport Magazine is a publication of the McFadden-Bartell Corp., with business offices in New York City. Each year Sport Magazine (hereinafter sometimes referred to as Sport or the magazine) awards a new Corvette automobile to the player selected by its editors (primarily by its editor in chief) as the outstanding player in the National Football League championship game. This award was won by John Unitas of the Baltimore Colts in 1958 and 1959 and by Norm Van Brocklin of the Philadelphia Eagles in 1960. A similar annual award is made to outstanding professional athletes in baseball, hockey, and basketball. The existence of the award is announced several days prior to the sporting event in question, and the selection and announcement of the winner is made immediately following the athletic contest. The Corvette automobiles are generally presented to the recipients at a luncheon or dinner several days subsequent to the sporting *430 event and a photograph of the athlete receiving the car is published in the magazine, together with an article relating to his performance during the particular athletic event. The Corvette awards are intended to promote the sale of Sport Magazine and their cost is deducted by the publisher for Federal income tax purposes as promotion and advertising expense.

The Corvette which is to be awarded to the most valuable player in the National Football League championship game is generally purchased by the magazine several months prior to the date the game is played, and it is held by a New York area Chevrolet dealer until delivered to the recipient of the award. In some years when the game is played in New York the magazine has had the car on display at the stadium on the day of the game.

On December 31, 1961, petitioner played in the National Football League championship game between the Green Bay Packers and the New York Giants. The game was played in Green Bay, Wis. Petitioner scored a total of 19 points during this game and thereby established a new league record. At the end of this game petitioner was selected by the editors of Sport as the most valuable player and winner of the Corvette, and press releases were issued announcing the award. At approximately 4:30 on the afternoon of December 31, 1961, following the game, the editor in chief of Sport informed petitioner that he had been selected as the most valuable player of the game. The editor in chief did not have the key or the title to the Corvette with him in Green Bay and the petitioner did not request or demand immediate possession of the car at that time but he accepted the award.

The Corvette which was to be awarded in connection with this 1961 championship game had been purchased by Sport in September of 1961. However, since the game was played in Green Bay, Wis., the car was not on display at the stadium on the day of the game, but was in New York in the hands of a Chevrolet dealership. As far as Sport was concerned the car was 'available' to petitioner on December 31, 1961, as soon as the award was announced. However, December 31, 1961, was a Sunday and the New York dealership at which the car was located was closed. Although the National Football Legal championship game is always played on a Sunday, Sport is prepared to make prior arrangements to have the car available in New York for the recipient of the award on that Sunday afternoon if the circumstances appear to warrant such arrangements— particularly if the game is played in New York. Such arrangements were not made in 1961 because the game was played in Green Bay, and, in the words of Sport's editor in chief, 'it seemed a hundred-to-one that * * * (the recipient of the award) would want to come in (to New York) on New Year's Eve to take possession' of the prize.

*431 On December 31, 1961, when petitioner was informed that he had won the Corvette, he was also informed that a luncheon was to be held for him in New York City on the following Wednesday by the publisher of Sport, at which luncheon his award would be presented. At that time petitioner consented to attend the luncheon in order to receive the Corvette. There was no discussion that he would obtain the car prior to the presentation ceremony previously announced. The lunch was held as scheduled on Wednesday, January 3, 1962, in a New York restaurant. Petitioner attended and was photographed during the course of the presentation of the automobile to him. A photograph of petitioner sitting in the car outside of the restaurant was published in the April 1962 issue of Sport, together with an article regarding his achievements in the championship game and the Corvette prize award. Petitioner was not required to attend the lunch or to pose for photographs or perform any other service for Sport as a condition or as consideration for his receipt of the car.

The fair market value of the Corvette automobile received by petitioner was $3,331.04. Petitioner reported the sale of the Corvette in his 1962 Federal income tax return in Schedule D attached thereto as a short-term gain as follows:

Kind of property	Date acquired	Date sold	Gross sales price	Depreciation allowed	Cost	Gain
1962 Corvette gift—						
Sport Magazine....................................	1962	1962	3,331.04	0.00	0.00	None

NOTE: Section 74(b) provides an exclusion from gross income any amount received as a prize or award if

(1) Such prize or award was made primarily in recognition of past achievements of the recipient in religious, charitable, scientific, educational, artistic, literary, or civic fields.

(2) Recipient was selected without any action on his part to enter the contest or proceeding.

(3) Recipient is not required to render substantial future services as a condition to receiving the prize or award.

Petitioner did not include the fair market value of this car in his gross income for 1962, or for any other year. McFadden-Bartell Corporation deducted its cost as a promotion and advertising expense.

ISSUE 2. THE THUNDERBIRD

When petitioner was discharged from the Army in late July of 1962 he contacted a friend of his who had a job with Ford Motor Co. and asked if the friend could arrange to provide a car for petitioner to drive while in Green Bay.[1] During 1962 the Ford Motor Co. through ***432** a dealership in Green Bay furnished petitioner a 1962 Thunderbird automobile. Title to this car was retained by Ford, and the automobile was replaced with a new one after a few months. Petitioner drove the two successive Thunderbirds a total of approximately 3,000 miles during 1962 and paid for the insurance and all operating expenses.

When petitioner was given the Thunderbird to use he did not have any arrangement or obligation to be photographed in the car, nor was he asked to make any personal appearances at Ford dealerships or to make any special effort to be seen by the public driving the car. However, petitioner was asked if he 'would come in and say hello to the kids at Milwaukee Punt, Pass and Kick Contest,' a contest for children regularly sponsored by Ford Motor Co. which petitioner and 'a few of the ball players' would regularly attend. The Ford Motor Co. has also furnished Thunderbirds to other members of the Packer team for their use in and around Green Bay.

Petitioner did not recognize or report gross income with respect to his use of the Thunderbirds during 1962. The fair rental value of petitioner's use of the Thunderbirds during 1962 was determined by respondent to be $600.

ISSUE 3. THE MINK STOLE

A few days after the Packers won the title to the Western Division of the National Football League in 1961[2] the players were informed that the Green Bay Packers, Inc., their employer, would give a fur stole to the wife, friend, or mother of each player on the team. Since petitioner was not married at the time, the Packers' head coach suggested that in his case the fur stole be given to his mother. Petitioner's mother received the fur stole before the end of 1961; she had it in her possession in Green Bay during the week prior to the championship game on December 31, 1961.

The cost of all of the fur stoles purchased by the Green Bay Packers, Inc., to be given away as described above was entered in the corporation's general journal on December 31, 1961, as 'Miscellaneous Player Expense.' The Green Bay Packers, Inc., employs the accrual method of accounting. No deduction was claimed by the Green Bay Packers, Inc., on its 1961 corporate income tax return for this expense. It was treated on said return under the heading 'other unallowable deductions,' and was described as 'Awards to players' wives, etc.'

The cost of these stoles to the Packers was $395 per stole, less an 8-percent discount. A total of 36 stoles were ordered and the invoices for all but 9 of these were dated subsequent to January 1, 1962. The invoice for the other 9 was dated December 29, 1961.

***433** Petitioner reported no gross income in any year with respect to the receipt by his mother of the fur stole in 1961. The fur stole had a fair market value of $395.

Respondent determined that petitioner's taxable income for 1962 was understated by reason of his failure to include therein ordinary income in the amount of $4,331.04 as reflected by the fair market value of the following items:

1962 Corvette	$3,331.04
Personal use of 1962 Thunderbird	600.00
Fur coat	400.00

Total.. 4,331.04

ULTIMATE FINDINGS OF FACT

The dominant motive and purpose of McFadden-Bartell in awarding the Corvette to petitioner was to promote and benefit their business of publishing Sport Magazine. Petitioner has failed to carry his burden of proving that the free use of Thunderbird automobiles provided by Ford Motor Co. to petitioner in 1962 was not taxable income or that the value thereof was other than as determined by respondent.

OPINION

ISSUE 1. THE CORVETTE

Petitioner alleged in his petition that the Corvette was received by him as a gift in 1962. However, at trial and on brief, he argues that the car was constructively received in 1961, prior to the taxable year for which the deficiency is being assessed. If this contention is upheld, the question of whether the car constituted a reportable item of gross income need not be considered. This argument is based upon the assertion that the announcement and acceptance of the award occurred at approximately 4:30 on the afternoon of December 31, 1961, following the game.

It is undisputed that petitioner was selected as the most valuable player of the National Football League championship game in Green Bay on December 31, 1961. It is also undisputed that petitioner actually received the car on January3, 1962, in New York. Petitioner relies upon the statement at the trail by the editor in chief of Sport that as far as Sport was concerned the car was 'available' to petitioner on December 31, 1961, as soon as the award was announced. It is therefore contended that the petitioner should be deemed to have received the value of the award in 1961 under the doctrine of constructive receipt.

The amount of any time of gross income is included in gross income for the taxable year in which received by the taxpayer unless such *434 amount is properly accounted for as of a different period. Sec. 451(a).[3] It is further provided in section 446(c) that the cash receipts method, which the petitioner utilized, is a permissible method of computing taxable income. The doctrine of constructive receipt is developed by regulations under section 446(c) which provides as follows:[4]

Generally, under the cash receipts and disbursements method * * * all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. * * *

The regulations under section 451 elaborate on the meaning of constructive receipt:[5]

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. * * *

The probable purpose for development of the doctrine of constructive receipt was stated as follows in Ross v. Commissioner, 169 F.2d 483, 491 (C.A. 1, 1948):

The doctrine of constructive receipt was, no doubt, conceived by the Treasury in order to prevent a taxpayer from choosing the year in which to return income merely by choosing the year in which to reduce it to possession. Thereby the Treasury may subject income to taxation when the only thing preventing its reduction to Possession is the volition of the taxpayer. * * *

However, it was held in the Ross case, at page 496, that the doctrine of constructive receipt could be asserted by a taxpayer as a defense to a deficiency assessment even though the item in controversy had not been reported for the taxable year of the alleged constructive receipt:

if these items were constructively received when earned they cannot be treated as income in any later year, * * * and in the absence of misstatement of fact, intentional or otherwise, the petitioner cannot be estopped from asserting that the items were taxable only in the years in which constructively received.

The basis of constructive receipt is essentially unfettered control by the recipient over the date of actual receipt. Petitioner has failed to convince us that he possessed such control on December 31, 1961, over the receipt of the Corvette. The evidence establishes that the Corvette which was presented to petitioner on January 3, 1962, was in the possession of a Chevrolet dealer in New York City on December 31, 1961. At the time the award was announced in Green Bay, *435 the editor in chief of Sport had neither the title nor keys to the car, and nothing was given or presented to petitioner to evidence his ownership or right to possession of the car at that time.

Moreover, since December 31, was a Sunday, it is doubtful whether the car could have been transferred to petitioner before Monday even with the cooperation of the editor in chief of Sport. The New York dealership at which the car was located was closed. The car had not been set aside for petitioner's use and delivery was not dependent solely upon the volition of petitioner. The doctrine of constructive receipt if therefore inapplicable, and we hold that petitioner received the Corvette for income tax purposes in 1962 as he originally alleged in his petition and as he reported in his 1962 income tax return.

We now must tackle the more basic question involving the Corvette which is whether the value of the car should be included in petitioner's gross income for the taxable year of receipt. Petitioner's offensive strategy on this issue is two-pronged. He contends (1) that the car was received as a gift and therefore properly excluded from gross income under section 102(a) and (2) that the car was received as a nontaxable prize or award under section 74.[6]

It is our opinion that certainly the donor's motive here precludes a determination that Sport made a gift of the Corvette to petitioner in 1962. It is clear that there was no detached and disinterested generosity. It also seems clear that the enactment of section 74 has had the desirable effect of eliminating the theory of gift exclusions from the field of prizes and awards. The Supreme Court has stated in Commissioner v. Duberstein, 363 U.S. 278, 290 (1960), with regard to gift exclusions that:

If there is fear of undue uncertainty or overmuch litigation, Congress may make more precise its treatment of the matter by singling out certain factors and making them determinative of the matter, as it has done in one field of the 'gift' exclusion's former application, that of prizes and awards. [FN12] (Footnote omitted.)

Petitioner undeniably received an award for his outstanding performance in the National Football League championship game. Under the provisions of section 74, gross income includes amounts received as prizes and awards unless section 117 (relating to scholarships and fellowship grants), or the exception set forth in subsection *436 (b) is applicable. Therefore, petitioner is precluded from effectively arguing that the award constituted a gift, and he can only hope to score on his argument that the award qualifies as an exception under section 74(b). In making this argument, petitioner shifts into a shotgun formation, contending that his accomplishments in the championship football game constitute educational, artistic, scientific, and civic achievements within the meaning of section 74(b). We believe that petitioner should be caught behind the line of scrimmage on this particular offense maneuver.

In construing the terms used in section 74(b), we are cognizant of the Supreme Court's recent reaffirmation of the principle that the words of revenue acts should be interpreted in their ordinary, everyday sense unless the internal structure of the statute or the legislative purpose indicates the propriety of a departure from a literal reading. See Malat v. Riddell, 383 U.S. 569 (1966). Petitioner relies primarily upon the opinions and beliefs of the editor in chief of Sport to establish the applicability of section 74(b).

In the opinion of this witness, the game of football is educational because it is taught in accredited colleges as part of certain physical education courses. Moreover, being a star football player is said to be an artistic achievement since such status 'calls for a degree of artistry.' Finally, since the skills of a football player are based upon techniques which encompass certain 'scientific' principles,[7] it is contended that petitioner's ability to excel in the execution of these techniques is a scientific achievement worthy of recognition by means of the award presented by Sport. Petitioner also argues that the award was made in recognition of civic achievement due to the alleged interest of the President of the United States in petitioner's application for leave from the Army to allow participation in the championship game.

We believe that the words 'educational,' 'artistic,' 'scientific,' and 'civic' as used in section 74(b) should be given their ordinary, everyday meaning in the context of defining certain types of personal achievement. Legislative history supports our belief. For example, the Senate report states that the provisions of section 74(b) are intended *437 to exempt from taxation such awards as the Nobel prize. See S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess., p. 178 (1954).

The legislative history of section 74 has been judicially interpreted as indicating that 'only awards for genuinely meritorious achievements were to be freed from taxation.' Simmons v. United States, 308 F.2d 160, 163 (C.A. 4, 1962). It was further stated in Simmons that all of the types of achievements singled out in section 74(b) resemble each other in general character since 'they all represent activities enhancing in one way or another the public good.' This interpretation is consistent with our view that the field of activity here in question, professional football, is not an activity which is 'educational,' 'artistic,' 'scientific,' or 'civic' in the traditional, ordinarily understood, and intended sense of these words.

We feel confident that Congress had no intention of allowing professional football to constitute a type of activity for which proficiency could be recognized with an exempt award under section 74(b). Professional football cannot be viewed as an 'educational,' 'artistic,' 'scientific,' or 'civic' field of endeavor as those terms are used in the statute no matter how fond of the sport we may be. The crucial question for qualification under section 74(b) is the nature of the activity awarded. Simmons v. United States, 308 F.2d 160 (C.A. 4, 1962). Had Congress intended to except prizes or awards for recognition of athletic prowess or achievement it could readily and easily have done so; as provided now however, no such exception can be read into the statutory language used. We hold that the value of the Corvette should have been included in petitioner's gross income for 1962. To hold otherwise would be a distortion of the commonly understood meaning of the words in controversy when read in the overall context of section 74.

ISSUE 2. THE THUNDERBIRD

Respondent has determined that $600, the fair rental value of petitioner's successive use of two 1962 Thunderbirds furnished by the Ford Motor Co., should have been included in petitioner's 1962 gross income. Petitioner argues that the free use of the cars was a gift or loan to him. Petitioner was not obligated to perform any special services for the Ford Motor Co. in return for the privilege of using the cars, and there was no employment contract involved. In this situation, it is contended that the free use of the Thunderbirds did not constitute taxable income. Petitioner paid for all the operating expenses of the cars and the insurance.

We agree with petitioner's position that a taxable benefit does not arise every time an item of personal property is loaned to another. It should be noted, however, that respondent is not attempting to levy *438 a tax on the value of a Thunderbird but only on the estimated rental value for the period of use. Thus, retention of title to the Thunderbirds by the Ford Motor Co. is irrelevant to the instant controversy.

Petitioner attempts to distinguish a loan from a gift so that each may constitute an alternative ground for avoiding taxation. it is clear that the cars were in effect loaned to petitioner. But this factor does not determine the taxability of the economic benefit arising from the free use of the cars.

The more serious attack directed against respondent's determination is based on the exclusion of gifts from gross income under section 102. Thus, if it could be found that the use of the Thunderbirds arose from a gift within the meaning of section 102, petitioner would escape taxation on the value of such use.

In deciding whether petitioner received a gift with respect to the use of the cars, we are governed by the principles enunciated in Commissioner v. Duberstein, 363 U.S. 278 (1960). According to Duberstein, the most critical consideration in making this determination is the transferor's 'intention.' The Duberstein case, at page 286, contains the following statement on this subject:

We take it that the proper criterion, established by decision here, is one that inquires what the basic reason for his (the transferor's) conduct was in fact— the dominant reason that explains his action in making the transfer * * *

The Court in Duberstein then proceeded to analyze applicable case law with respect to what types of motives or intentions of a transferor are indicative of a gift transfer qualifying under section 102. This analysis has been concisely summarized in DeJong v. Commissioner, 309 F.2d 373, 379 (C.A. 9, 1962), affirming 36 T.C. 896 (1961), as follows:

The value of a gift may be excluded from gross income only if the gift proceeds from a 'detached and disinterested generosity' or 'out of affection, admiration, charity or like impulses' and must be included if the claimed gift proceeds primarily from 'the constraining force of any moral or legal duty' or from 'the incentive of anticipated benefit of an economic nature.' * * *

The determination of the gift issue when approached with the Duberstein rationale is essentially dependent upon 'the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case.' Commissioner v. Duberstein, supra at 289.

The burden of proof to establish that the respondent's determination was wrong rests on petitioner. Due to the lack of evidence pertaining to the circumstances surrounding the loan of the Thunderbirds, we can only speculate about the reasons of the Ford Motor Co. for authorizing the loan. While it is possible that Ford was motivated by detached and disinterested generosity, it seems more likely that officials *439 of the Ford Motor Co. believed that the use of Thunderbirds by well-known and readily recognizable football stars of national renown would constitute valuable implied personal endorsements favorable to the sales image of Thunderbirds. This speculation is further supported by the fact that the Ford Motor Co. also furnished Thunderbirds to certain other members of the Packer team. Therefore, in the complete absence of any evidence to the contrary, it is logical to conclude that the Ford Motor Co. was motivated by commercial considerations in furnishing Thunderbirds to petitioner free of charge.

We feel that this factual determination is 'based in the sort of informed experience with human affairs that the fact-finding tribunals should bring to this task.' Commissioner v. Duberstein, supra at 292. The burden on the taxpayer to introduce facts to establish the existence of a gift has not been met.

The petitioner has been unsuccessful in his attempt to persuade us that the free use of the Thunderbirds was a gift or is specifically excluded from taxation by any applicable section of the Code. We must still decide, however, whether an economic benefit of the type here received is includable in gross income under the particular circumstances in this case.

Respondent argues that petitioner received an economic benefit solely because of his status as a football celebrity, and that the measure of the economic benefit is the rental value of petitioner's use of the cars. This is the amount of money that the average man on the street would have to expend the obtain the same us. Thus, for all practical purposes, petitioner was enriched in an amount equal to what the normal person pays for renting Thunderbirds.

Section 61(a) provides that gross income includes 'all income from whatever source derived.' The Supreme Court in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), and General Investors Co. v. Commissioner, 348 U.S. 434 (1955), construed the phrase 'gains or profits and income derived from any source whatever,' which constituted part of the definition of gross income in section 22(a) of the Internal Revenue Code of 1939, as encompassing punitive damages for fraud and antitrust violations involved in Glenshaw Glass and insider profits involved in General Investors.

Certain language in the preceding two cases supports the proposition that gross income is an all-inclusive concept. In Glenshaw Glass, at pages 431-433, the Court stated:

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. * * *

* * * We would do violence to the plain meaning of the statute and restrict a clear legislative attempt to bring the taxing power to bear upon all receipts constitutionally taxable were we to say that the payments in question here are not gross income. * * *

*440 The Court utilized similar language in General Investors, at page 436:

As in Glenshaw, the taxpayer realized the money in question free of any restrictions as to use. The payments in controversy were neither capital contributions nor gifts. * * * In accordance with the legislative design to reach all gain constitutionally taxable unless specifically excluded, we conclude that the petitioner is liable for the tax * * *

The elimination of the words 'gains or profits' from the definition of gross income in the 1954 Code has not affected the importance of Glenshaw Glass and General Investors. In referring to the significance of this deletion in view of the legislative history of section 61(a), the

Court in Glenshaw Glass, at page 432, made the following comment:

Nor does the 1954 Code's[FN9] legislative history, with its reiteration of the proposition that statutory gross income is 'all-inclusive,'[FN10] give support to respondents' position. The definition of gross income has been simplified, but no effect upon its present broad scope was intended. [FN11] * * * (Footnotes omitted.)

We hold that the free use of the Thunderbirds constituted income to petitioner within the meaning of section 61. The rationale of Glenshaw Glass and General Investors seems equally applicable to the present situation. Petitioner received a valuable benefit which was fully realized by him in a business context.

This case is clearly distinguishable from the bargain purchase line of cases where the benefit is often not realized until the subsequent sale of the property at which time the bargain element may be ascertained with accuracy and accordingly taxed. See Palmer v. Commissioner, 302 U.S. 63 (1937); Commissioner v. LoBue, 351 U.S. 243 (1956). There is no possibility of postponing the incidence of taxation on the benefit received by petitioner in furtherance of sound tax administration goals; the benefit of using the cars was realized in 1962 and it must be taxable in the year of receipt or it will never be taxed. In receiving the free use of the Thunderbirds to use as he saw fit, petitioner received additions to gross income. See William A. Brown, 47 T.C. 399 (1967).

It seems clear that a person may receive a taxable benefit even though it is not 'earned' in the sense that special duties in return for the benefit are required. Due to petitioner's unique status as a football celebrity, his endorsement of commercial products is obviously valuable to various business interests. His 1962 income tax return evidences that fact. In our view, the essence of the transaction was the endorsement element. The Ford Motor Co. received the intangible benefits of petitioner's implied personal endorsement of Thunderbirds by authorizing the free use of the cars. Petitioner benefited by this arrangement in an amount equal to the rental value of his use of the Thunderbirds. Thus, there was consideration for entering into the *441 arrangements on either side. In such a commercial context, we think that respondent's determination should be upheld, particularly since petitioner produced no evidence to indicate a contrary conclusion.

The fact that petitioner could only realize the benefit by doing what was valued by the Ford Motor Co., using the Thunderbirds, is certainly unusual. However, this factor should not determine the taxability of the benefit. The rent-free occupancy of a house has often been held to be income to the occupier despite the fact that the benefit could only be realized by actually living in the home. See Chandler v. Commissioner, 119 F.2d 623 (C.A. 3, 1941); Paulina duPont Dean, 9 T.C. 256 (1947), and Charles A. Frueauff, 30 B.T.A. 449 (1934).

It is considered opinion, therefore, for all of the foregoing reasons, that petitioner should have included the value of the use of the Thunderbirds in his gross income for the taxable year 1962. Respondent has determined that value as $600, and petitioner has not produced evidence to overcome the presumption of correctness of that determination.

ISSUE 3. THE MINK STOLE

Respondent has determined that petitioner's gross income for 1962 should have included the fair market value of a fur stole received by petitioner's mother from the Green Bay Packers, Inc. If for no other reason, due to our factual finding that petitioner's mother actually received the stole before the end of 1961, and because petitioner utilized the cash receipts method of computing income, we must hold that the receipt of the fur stole did not constitute income to petitioner in 1962. Since petitioner's taxable year 1961 is not before us, we are precluded from further consideration of this issue.

Decision will be entered under Rule 50.

All Citations

47 T.C. 428

Footnotes

1 Petitioner had sold his prize Corvette in Kansas City 4 or 5 months after he received it.

2 We take judicial notice that this division title was won prior to the Dec. 31, 1961, championship game in which the Packers played the winners of the Eastern Division.

3 All section references are to the Internal Revenue Code of 1954 unless otherwise indicated.

4 Sec. 1.446-1(c)(1)(i), Income Tax Regs.

5 Sec. 1.451-2(a), Income Tax Regs.

6 SEC. 74. PRIZES AND AWARDS.

(a) GENERAL RULE.-- Except as provided in subsection (b) and in section 117 (relating to scholarships and fellowship grants), gross income includes amounts received as prizes and awards.

(b) EXCEPTION.— Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if—

(1) the recipient was selected without any action on his part to enter the contest or proceedings; and

(2) the recipient is not required to render substantial future services as a condition to receiving the prize or award.

7 The record contains the following statements by the editor in chief of Sport describing some of the 'scientific' principles of football:

'The players have large notebooks that they have at the beginning of the practice season that contain intricate plays. You have to be somewhat of a mathematician to digest them. * * *

'Part of the training, at least related to football, professional football, is that the athlete must know a certain number of plays a year; must know how to play his position in many different ways; must be able to look at a film of another team and decide how to play against his particular opponent; must look at his own films and know what he has done right and what he has done wrong, and whether he has blocked off the wrong shoulder or something like that. He must know what his teammates are doing in relation to a formation, in relation to specific plays.

'This is all in the area of technique, and is quite complicated, and in a sense I think scientific.'

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83 T.C. 755
United States Tax Court

CECIL B. FURSTENBERG, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19977-80.
|
Filed November 26, 1984

Synopsis

From Jan. 1, 1975 to Dec. 22, 1975, petitioner was a United States citizen. On Dec. 23, 1975, petitioner adopted Austrian citizenship, thereby losing her United States citizenship. During 1975, petitioner received distributions from two complex trusts of which she was a beneficiary.

HELD: Petitioner did not have tax avoidance as one of her principal purposes in expatriating; thus her income is not taxable under sec. 877, I.R.C. 1954.

HELD, FURTHER: Petitioner is taxable at the graduated rates applicable to United States citizens on an accumulation distribution from a complex testamentary trust received by her before the date of her expatriation.

HELD, FURTHER: Petitioner is taxable at the flat French Tax Treaty rate on a distribution of distributable net income from a complex inter vivos trust because she neither actually nor constructively received the distribution before the date of her expatriation.

Attorneys and Law Firms

*755 DAVID W. JOHNSON and SHERI A. WILCOX, for the respondent.

CHARLES W. HALL, WILLIAM S. LEE, and STEPHEN M. FELDHAUS, for the petitioners.

Opinion

FEATHERSTON, JUDGE:

Respondent determined deficiencies in petitioner's Federal income taxes as set forth below:

Year	Deficiency
1975..	$595,017
1976..	1,476,718
1977..	3,207,600

After concessions, the issues for decision are as follows:

1. Whether petitioner's loss of her United States citizenship on December 23, 1975, had as one of its principal purposes the *756 avoidance of United States taxes within the meaning of section 877(a); [1]

2. Whether, even if we find that petitioner had tax avoidance as one of her principal purposes in expatriating, the French Tax Treaty, rather than section 877, governs the taxation of petitioner's capital gains and United States source dividends and interest after the date of her expatriation; and

3. In the alternative, for the year 1975, whether petitioner is taxable on distributions from two trusts at the graduated tax rates applicable to United States citizens, or at the lower flat French Tax Treaty rate of 15 percent. Resolution of this issue turns on: (a) Whether an accumulation distribution in the amount of $830,753.13 from the Testamentary Trust of petitioner's mother, Sarah Campbell Blaffer, a complex trust, although actually distributed before petitioner's expatriation, is includible in petitioner's income for the period after she became a nonresident alien; [2] and (b) whether petitioner was in constructive receipt before December 23, 1975, the date of her expatriation, of a distribution of distributable net income in the amount of $128,792.71 from the Cecil A. Blaffer Trust No. 1, a complex inter vivos trust.

FINDINGS OF FACT

At the time she filed her petition in this case, petitioner resided at 34 Boulevard D'Italie, Monte Carlo, Monaco. During the years at issue, petitioner kept her books and records and filed her Federal income tax returns on a calendar year basis using the cash receipts and disbursements method of accounting under section 446(c)(1).

PETITIONER'S EARLY BACKGROUND

Petitioner was born on December 17, 1919, in Houston, Texas. She is the daughter of Sarah Campbell Blaffer and Robert Lee *757 Blaffer; her father was one of the founders of Humble Oil & Refining Co., the predecessor of Exxon Corporation.

Petitioner's formal education began at Kincaid, a day school in Houston. She then went to the Ethel Walker School in Connecticut. During World War II, petitioner attended a French school for girls in New York where instruction was exclusively in French. She later studied languages and art at the University of Mexico.

Because of the financial success of her father, petitioner's family was able to travel a great deal. As a child, petitioner traveled extensively with her family, visiting Europe, in particular, France.

Petitioner had a close relationship as a child with her governess, a Frenchwoman named Suzanne Glemet, described by petitioner as a 'second mother.' She spent several summers in France at the family home of her governess in Charent, in the southwest part of France near Bordeaux.

Petitioner learned to speak French as her 'first language,' i.e., before she learned to speak English. She is so fluent in French, in fact, that she is taken for a French person when she speaks. In addition to English and French, petitioner also speaks Spanish and German.

PETITIONER'S MARRIAGES TO E. J. HUDSON AND RICHARD J. SHERIDAN

On August 7, 1945, petitioner married E. J. Hudson (Hudson), a petroleum engineer. Petitioner and Hudson had two sons, Edward Joseph Hudson, Jr. (Joe Hudson), born June 8, 1948, and Robert Lee Blaffer Hudson (Lee Hudson), born April 4, 1951.

The Hudsons resided in Houston during their marriage. They did, however, take many trips to and spent extended periods of time in Europe, particularly in France, with their children. On one occasion, the Hudsons rented a home near Paris, and on two other occasions, they rented a home in the south of France.

Petitioner's sons were educated for the most part in the United States. Both children, however, attended school in Paris for one year and in the south of France for one year. Both of petitioner's sons learned French as children, and both became fluent in that language.

*758 During her marriage to Hudson, petitioner continued to travel as extensively as she had as a child. Her travel was 'not always to his (Hudson's) liking.' Petitioner was divorced from Hudson on March 14, 1963. After her divorce from Hudson, petitioner continued to travel frequently to Europe, including France and some of the other countries.

On January 25, 1968, petitioner married Richard M. Sheridan (Sheridan), an international executive of Mobil Oil Corporation, in Tokyo, Japan. Petitioner resided with Sheridan in Tokyo from January 1968 to June 1968; they moved to London in September 1968. When she moved to London, petitioner moved her china, silver, and heirlooms there from Houston.

As of the time of their move to London, Sheridan would have been eligible for retirement from Mobil in approximately 8 or 9 years. Petitioner owned some real estate in the south of France;[3] she discussed with Sheridan the possibility of their settling there permanently after his retirement. Initially, Sheridan agreed to such a plan, but during the course of their marriage, he changed his mind. Petitioner separated from Sheridan in the summer of 1970, and was divorced from him on November 29, 1971.

PETITIONER'S MOVE TO PARIS

In August 1969, petitioner obtained an option for the purchase of an apartment in a building to be constructed at 33 Avenue Foch in Paris; she purchased the apartment in January 1970. When construction of the apartment was completed, petitioner moved in, taking her personal belongings from London. It is stipulated that petitioner was a resident of France from 1970 through 1977, the last year here in controversy.

Petitioner's apartment in Paris was staffed by domestic help who kept the apartment open regardless of whether petitioner was staying there or traveling. Petitioner kept an automobile in Paris and maintained a bank account there; she subscribed to a French newspaper. She attended the Anglican Church *759 located on Avenue George V. Petitioner was a resident member, during the years at issue, of the Polo Club in Paris and was also a Paris resident member of Le Cercle du 33 Avenue Foch, another social club.

By this time in her life, petitioner had a great many friends in France and other European countries; indeed, the majority of her close friends were in Europe. While living in Paris, petitioner pursued her interest in the art world, visiting many museums and attending art exhibits, openings and auctions both in Paris and elsewhere in Europe.[4] She attended music festivals in Bayreuth and Munich in West Germany; in Salzburg and Vienna in Austria; and in the south of France and Italy.

PETITIONER'S MARRIAGE TO PRINCE TASSILO VON FURSTENBERG

Petitioner first met Prince Tassilo von Furstenberg (Furstenberg) in Trieste, Italy, in 1961. When they met, petitioner was in the process of obtaining her divorce from Mr. Hudson. Furstenberg, who was living in Italy at the time, was married to Clara Agnelli (Agnelli), an Italian woman from whom he had been separated for years. At that time, however, divorces were prohibited under Italian law.

Petitioner spent time with Furstenberg in Trieste, where he escorted her to parties and introduced her to relatives and friends. They met again a few weeks later in Austria during the music festival in Salzburg; petitioner accompanied Furstenberg to his nearby hunting lodge to meet relatives and friends. As early as their meetings in 1961, petitioner and Furstenberg found that they were compatible and congenial. They discussed the subject of marriage; however, neither of them was free to marry at that time.

During the period from 1961 to 1966, petitioner saw Furstenberg when she went to Europe and they corresponded frequently. After her divorce from Sheridan in 1971, petitioner saw Furstenberg in Paris, Salzburg, and Vienna in 1972 and *760 they spent a great deal of time together. By the early 1970's, Italian law had been changed to permit divorces and Furstenberg was divorced from Agnelli.

Sometime during the first 3 months of 1975, petitioner and Furstenberg decided to marry. At that time, petitioner was 55 years of age, and Furstenberg was 71 years of age; petitioner's two sons and Furstenberg's three children were living independently of their parents. Although the prior marriages of petitioner and Furstenberg had been unsuccessful, they felt that they were compatible and that they 'could make a success' of their marriage.

At the time of their decision to marry in 1975, petitioner was living in Paris and Furstenberg was living most of the time in Italy. They discussed where they would make their home after the marriage and agreed to live for the time being in petitioner's apartment in Paris. With respect to where they might live later, they were both very partial to the south of France.

They also discussed the possibility of living in Austria. Furstenberg, an Austrian citizen, owned a hunting lodge surrounded by some 70 acres of land in the Austrian town of Strobl on St. Wolfgang Lake. The land and lodge were purchased by Furstenberg's father and were the last of the family properties owned by Furstenberg. Petitioner was not adverse to the idea of living in Austria; however, although Furstenberg was emotionally attached to the property in Strobl, it was not equipped for winter living and he did not like living in such cold weather.[5] Further, Furstenberg had been living outside of Austria for several years, and he decided that he preferred to live with petitioner in Paris for the time being.

Petitioner and Furstenberg were married in Paris on October 17, 1975, in a civil ceremony attended only by their children and a few close friends. A buffet luncheon reception was given after the wedding at the apartment of

Baron and Baroness Hubert von Pantz, Austrian friends of the Furstenbergs, and was attended by approximately 150 persons including Baron Otto Eiselberg, the Austrian Ambassador to France. The ambassador, assuming that petitioner would adopt the *761 Austrian citizenship of her new husband, assured petitioner that he could simplify naturalization procedures for her.

The Furstenbergs honeymooned in the United States from October 20, 1975 to December 19, 1975. While on their honeymoon they visited New York, Houston, San Antonio, Dallas, and Victoria. They visited Furstenberg's son and grandchildren and petitioner introduced her new husband to family and friends whom he had not previously met.

As of the time of trial, petitioner had been married to Furstenberg for over 8 years. Petitioner and Furstenberg plan at their deaths to be buried at the Furstenberg family burial plot in Strobl, Austria.

PETITIONER'S ADOPTION OF AUSTRIAN CITIZENSHIP

Members of Furstenberg's family first became princes of the Holy Roman Empire in 1664. He was and is a citizen of Austria; his Austrian heritage and ties are very important to him. At the time they decided to marry in early 1975, Furstenberg explained to petitioner the importance of his Austrian heritage and expressed to her his desire that she adopt Austrian nationality.

Cognizant of the fact that 'it was more or less expected of that type of European aristocracy,' petitioner confirmed her decision with her commitment to Furstenberg that she would be 'very proud to marry him, bear his name, his title, and his nationality.' Although she had been living outside of the United States for some years, at no time did petitioner ever consider the possibility of adopting European citizenship until her engagement to Furstenberg.

Petitioner felt that part of bearing Furstenberg's name and title 'was to be Austrian the way he wished it.' Further, by 1975, petitioner had been living in Europe continuously for 7 years; she preferred living in Europe more than anywhere else. Finally, petitioner felt that by adopting Austrian citizenship, she 'was going back to (her own) * * * European heritage and roots.'[6] At the time petitioner agreed to adopt *762 Furstenberg's Austrian nationality, in early 1975, when they decided to marry, she did not know that by so doing, she would lose her United States citizenship. Further, she did not know what the tax consequences of such an action would be.

During their honeymoon, Furstenberg reminded petitioner of her agreement to become an Austrian citizen. Petitioner told her husband that she would attend to the matter as soon as she could.

The Furstenbergs returned to Paris from their honeymoon in the United States on December 19, 1975. They had planned to go to Vicenza in northern Italy to spend Christmas Eve with one of petitioner's sons and his wife and one of Furstenberg's sons. Knowing that her husband wished her to adopt Austrian citizenship as soon as possible, petitioner went to the Austrian consulate in Paris to make her application for Austrian citizenship on December 23, 1975. In her words, she chose that date because,

> It just happened to be an afternoon that I could get off, and I knew that my husband wanted me to do it before the end of the year. He had mentioned to do it as soon as possible, and we were leaving that night for Italy. And I happened * * * to have that time * * * to go down and make the application.

As he had promised at petitioner's wedding reception, the naturalization process was simplified for petitioner at the request of Baron Eiselberg, Austrian Ambassador to France. Petitioner obtained Austrian citizenship by naturalization on her own application on December 23, 1975; she thereby lost her United States citizenship on the same day under the provisions of section 349(a)(1) of the Immigration and Nationality Act of 1952, 66 Stat. 267.

PETITIONER'S DISCUSSIONS WITH HER ACCOUNTANT

During the 1970's, petitioner's United States tax returns were prepared by Arthur Young & Company, an accounting firm. The individual at Arthur Young with whom petitioner discussed her tax returns was Gordon S. Moore (Moore), who is now deceased. Petitioner's practice was to meet with Moore once a year to discuss her current year's tax return, although some years she may have met with Moore twice.

*763 In late April or early May 1975, after her decision to marry Furstenberg and adopt his citizenship, petitioner met with Moore when she came to Houston to attend to her mother who was terminally ill. At their meeting, petitioner informed Moore that she intended to marry Furstenberg, adopt Austrian citizenship, and live with her husband in Paris. She asked Moore to advise her concerning the income tax consequences of her plans.

Moore informed petitioner at this meeting that her plan to marry and adopt Austrian nationality would 'complicate' her taxes. He warned petitioner about French taxes, telling her that the French taxes could be very high, and that they were rising. Moore told petitioner that he would look into it for her. Petitioner and Moore did not discuss the two trust distributions which petitioner later received in 1975; nor did they discuss the possibility of any sale of securities. [7] Petitioner had no further discussions with Moore during 1975 after this meeting.

Petitioner's next meeting with Moore did not occur until March 1978, after her expatriation, when petitioner was in Houston for a trustees meeting of the Sarah Campbell Blaffer Foundation. [8] Moore advised petitioner that by adopting Austrian citizenship, she had put herself 'in a position to be challenged by the tax authorities in the United States.' In addition, she had exposed herself to 'double taxation with the French and the Americans. ' Petitioner did not understand the full implications of what double taxation could mean to her, but she found it 'alarming.' Moore further advised petitioner of the existence of a tax treaty between France and the United States and suggested that she seek legal advice.

*764 1975 DISTRIBUTION FROM THE TESTAMENTARY TRUST OF SARAH CAMPBELL BLAFFER

Petitioner was one of four beneficiaries of the remainder of a complex testamentary trust (or trusts consisting of shares thereof) established under the will of her father, Robert L. Blaffer, designated as the Testamentary Trust of Sarah Campbell Blaffer (the Testamentary Trust). Petitioner's mother, Sarah Campbell Blaffer, who was the sole beneficiary of the Testamentary Trust during her lifetime, died on May 11, 1975. The will provided that upon Sarah Campbell Blaffer's death and certain stated conditions, the trust for each beneficiary was to terminate and such beneficiary was to receive her one-fourth share outright free and clear of the trust. Petitioner met the conditions stated in her father's will and, upon her mother's death, became entitled to her share of the trust assets.

Texas Commerce Bank was the executor of Sarah Campbell Blaffer's estate, a very large estate. Included in the estate were many assets which required 'quite a bit' of activity by the bank in connection with its administration. The sole surviving trustee of the Testamentary Trust was Mrs. Jane Owen, petitioner's sister. Mrs. Owen employed Texas Commerce Bank in an agency capacity to assist her in her duties as trustee of the Testamentary Trust to accomplish the transfer of some 39 different stocks to the beneficiaries of the Testamentary Trust.

James M. Barr (Barr), a Texas Commerce Bank trust officer, wrote to the various transfer agents for each of the 39 securities requesting the reissuance of the shares held by the Testamentary Trust in the names of the four beneficiaries of the trust. Most of the letters to the transfer agents are dated December 22, 1975; a few are dated later. The task of writing to the transfer agents was handled as a routine matter by the bank personnel involved.

Texas Commerce Bank was not requested to assist with the transfer of Exxon stock to the beneficiaries of the Testamentary Trust. Mrs. Ora V. Howton (Mrs. Howton), manager of Mrs. Blaffer's office, handled that particular transfer herself because she was proud of her connection with Exxon; she felt she was part of the Humble Oil family; and she knew the *765 personnel at the First National City Bank who did the transfer work with respect to the Exxon stock.

By letter dated November 18, 1975, Mrs. Owen sent 122,167 shares of Exxon Corporation stock, an asset of the Testamentary Trust, to Mr. George Grosz, a trust officer with the First National City Bank, the transfer agent for Exxon Corporation. Mrs. Owen's letter includes instructions concerning the reissuance of the Exxon stock, requesting that 30,541 shares, i.e., one-fourth of the total shares, be reissued in petitioner's name. Pursuant to Mrs. Owen's request, the 30,541 shares of Exxon stock, having a total value of $2,653,249, were reissued in the name of petitioner on the books of Exxon's transfer agent on November 20, 1975.

Petitioner knew that after the death of her mother, she would be receiving distributions from the Testamentary Trust. During 1975 and 1976, petitioner had a close relationship with her sister, Mrs. Owen, the trustee of the Testamentary Trust, and would not have hesitated to ask her sister to assist her in any reasonable manner. Petitioner felt that her sister would have accommodated any reasonable request for her. Petitioner, however, did not give anyone, in particular her sister; Mrs. Owen, or the personnel at the Texas Commerce Bank, any instructions or make any requests with respect to the timing of any distributions from the Testamentary Trust.

Knowing that she was to receive distributions from the Testamentary Trust, indeed that 'they had begun distributing it,' and knowing that she would be out of the United States for an extended period when such distributions would be made, petitioner executed, on December 17, 1975, before she left for Europe after her honeymoon in the United States, a Limited Power of Attorney (power of attorney) appointing her son, Joe Hudson, as her attorney-in-fact for the purpose of receiving petitioner's portion of the assets to be distributed from the Testamentary Trust. Petitioner also executed a Partial Receipt and Release dated December 17, 1975 (partial receipt), in connection with the distribution to her of various assets, including 30,541 shares of Exxon stock, from the Testamentary Trust.

It has been stipulated that petitioner received distributions from the Testamentary Trust in 1975, before the date of her expatriation, in the amount of $995,724.76 consisting of an ***766** accumulation distribution of $830,753.13 and $164,971.63 in distributable net income.

1975 DISTRIBUTION FROM THE CECIL A. BLAFFER TRUST NO. 1

On December 28, 1934, petitioner's parents established an inter vivos trust, the Cecil A. Blaffer Trust No. 1 (Trust No. 1), of which petitioner was the sole beneficiary. Trust No. 1 was a complex trust with a taxable year ending December 31. In 1975, Texas Commerce Bank was the trustee of Trust No. 1; Leslie C. Lewis (Lewis), a senior vice-president and trust officer at Texas Commerce Bank, who had worked on the Blaffer family trust accounts since he returned to Texas Commerce Bank from World War II, was the trust officer in charge of the administration of Trust No. 1 in 1975.

With respect to distributions, Section II of the Cecil Amelia Blaffer Trust Agreement, the governing instrument of Trust No. 1, provides as follows:

SECTION II. The principal and the income of the Trust Fund shall be held in trust for the benefit of my said daughter, CECIL AMELIA BLAFFER, until she attains sixty-five (65) years of age: PROVIDED, that when our said daughter becomes thirty (30) years of age, the Trustee shall pay over to her during EACH YEAR THEREAFTER, that fraction of the undistributed portion of the principal of the Trust Fund represented by the figure one over the number of years remaining until our said daughter attains the age of sixty-five (65) years. That is to say, when our said daughter becomes thirty (30) years of age, DURING THE FIRST YEAR THEREAFTER there shall be distributed to her one-thirty-fifth ($^1/_{35}$) of the undistributed portion of the principal of the Trust Fund; during the second year, one-thirty-fourth ($^1/_{34}$); etc., until the thirty-fifth year after our said daughter attains thirty (30) years of age is reached, when the remaining undistributed portion of the principal of the Trust Fund shall be distributed to our said daughter. The income of the Trust Fund shall be accumulated and added to the principal of the Trust Fund and distributed as a part thereof in accordance with the foregoing provisions: PROVIDED, That our said daughter during any calendar year after she attains legal age shall have the right to elect in writing to require the Trustee to distribute to her during the succeeding calendar year the income, in whole or in part, of the Trust Fund accruing during each succeeding calendar year; and the election of our said daughter as to the amount of such income to be distributed to her shall be binding in all respects upon the Trustee. SAID PAYMENTS OF PRINCIPAL AND INCOME of the Trust Fund SHALL BE MADE QUARTERLY TO our said daughter ON JANUARY 1ST, APRIL 1ST ,JULY 1ST AND OCTOBER 1ST, OF THE YEAR IN WHICH THEY RESPECTIVELY BECOME DUE. (Emphasis added.)

*767 Although Section II as recited above provided for quarterly distributions to petitioner of the applicable fractional portion of principal in the year succeeding each birthday on which the fraction was calculated, Texas Commerce Bank's administrative practice, which was consistent with that which had been followed by the prior trustee of Trust No 1, was to make a single annual distribution at some time following petitioner's birthday. Texas Commerce Bank's normal administrative practice was to calculate the book value of the assets of Trust No. 1 as of petitioner's birthday each year, and to apply the applicable fraction as provided in Section II of the trust agreement in determining the amount to be distributed to the petitioner.

Distributions following petitioner's birthday for the years 1970 through 1976 were recorded on the bank's books as follows:

Date distribution calculated	***Date distribution recorded in Texas Commerce Bank records***
Dec. 17, 1970	Dec. 30, 1970
Dec. 17, 1971	Dec. 23, 1971
Dec. 17, 1972	Dec. 22, 1972
Dec. 17, 1973	Jan. 25, 1974
Dec. 17, 1974	Dec. 17, 1974
Dec. 17, 1975	Dec. 23, 1975
Dec. 17, 1976	Mar. 7, 1977

Each of the foregoing dates on which the respective distributions were recorded was probably the date on which the check for the distribution was written; the check, however, could have been recorded the day after it was written.

The distribution from Trust No. 1 with respect to petitioner's birthday on December 17, 1975, was made by Texas Commerce Bank in the amount of $128,792.71 by its check dated December 22, 1975. Lewis transmitted the check to petitioner with his letter dated December 22, 1975, addressed to petitioner in care of Mrs. Howton, manager of petitioner's mother's office. Lewis could not recall whether he hand-delivered this letter or put it in the mail. The check was deposited in petitioner's account on December 23, 1975.

Petitioner herself never communicated with Lewis concerning distributions from Trust No. 1; only Mrs. Howton communicated with Lewis with respect to such distributions. *768 Mrs. Howton, however, never communicated with Lewis concerning the timing of any distributions to petitioner from Trust No. 1.

Petitioner did no planning with respect to the 1975 distribution to her from Trust No. 1; nor did she do anything with respect to the timing of such distribution. She did not communicate to Texas Commerce Bank at any time prior to December 23, 1975, any information concerning her intention to adopt Austrian citizenship. During 1975, petitioner did not even know when the 1975 distribution from Trust No. 1 had been received for her account.

Lewis did not do, nor did he cause anyone else at Texas Commerce Bank to do, any planning with respect to the 1975 distribution to petitioner from Trust No. 1, other than to take the routine administrative steps which had been followed for a number of previous years. Indeed, Lewis was not aware of any action being taken with respect to the 1975 distribution which differed from the routine which had been followed in previous years. He knew of no particular reason for selecting December 22, 1975, as the date on which the distribution check was transmitted to petitioner.

Because Lewis had been the Texas Commerce Bank trust officer in charge of the Blaffer family accounts for many years prior to 1975, it would have been usual procedure for him to be informed of any matters affecting any of the Blaffer family accounts with the bank. On December 23, 1975, Lewis had no knowledge with respect to petitioner's intention to adopt Austrian citizenship.

SALES OF SECURITIES BY PETITIONER IN 1976 AND 1977

As of December 23, 1975, the date of her expatriation, petitioner had no intention of selling any securities. After her meeting with her accountant, Mr. Moore, in March 1976, petitioner understood that as a result of the distribution of securities and other assets to her from the Testamentary Trust which 'considerably increased' her dividend income, she faced 'dangerous exposure' to potential tax problems, particularly to the possibility of double taxation of her dividends by the United States and France. At some time after her March 1976 meeting with Mr. Moore, however, during 1976 and 1977, petitioner sold more stock than she had ever sold before.

*769 In 1976, petitioner realized a net capital gain in the amount of $2,601,680.06 from the sale of securities. Many of the securities sold were those which had been distributed to petitioner from the Testamentary Trust. In 1977, petitioner again realized a net capital gain of $7,219,440.35 from the sale of various securities. The great bulk of this gain, $7,080,908.82, resulted from her sale of 148,742 shares of Exxon stock.

Petitioner delayed her sale of the Exxon stock until at least the summer of 1977 because she was 'hesitant to part with it.' She considered Exxon to be part of her 'father's endeavor' and it was obviously sentimental to her. Petitioner's mother, during her lifetime, had always cautioned her children not to sell their Exxon stock.

PETITIONER'S TAX RETURNS: 1974—1977

Petitioner filed income tax returns and reported income and tax liability for 1974 through 1977 as described below:

1974: As a United States citizen for the entire year, petitioner filed a Form 1040 for 1974. She reported total income of $766,297.08, consisting principally of dividend income from various sources in the amount of $688,766.55. Her total United States tax liability for the year, computed under the graduated rates applicable to United States citizens, was $155,990.54.

1975: For 1975, petitioner filed a Form 1040NR, U.S. Nonresident Alien Income Tax Return, attaching to it a Form 1040. Schedule 1 of the Form 1040NR is entitled 'General Information' and states in relevant part:

Taxpayer was a resident of France during the entire year of 1975. She was a U.S. Citizen until December 23, 1975 on which date she acquired the nationality of Austria by naturalization.

* * *

Taxpayer's income tax liability for the period from January 1, 1975 to December 22, 1975 is computed on Form 1040 and supporting schedules attached.

Taxpayer's income during the period from December 23, 1975 to December 31, 1975 is reported on page 4 of Form 1040NR. The tax on dividends is computed at 15 percent in accordance with French Income Tax Treaty, Article 9, copy of which is attached.

Taxpayer received distributions in 1975 from The Testamentary Trust for Sarah C. Blaffer. Copies of schedules K-1 and J are attached.

*770 On the Form 1040 attached to the Form 1040NR, petitioner reported the following as income received prior to December 23, 1975, the date of her expatriation:

Dividends (less $100 exclusion)	$644,659.19
Interest	2,570.99
Capital gains (after sec. 1202 deduction)	488.55

Rental or royalty income (net)	56,603.32
Director fees	1,200.00
Prize	1,000.00
Total	706,522.05

The tax on the income reported on the Form 1040 as received prior to December 23, 1975, was computed under the graduated tax rates applicable to United States citizens.

On the Form 1040NR, petitioner reported the following as income received during the period December 23, 1978 through December 31, 1975, after her expatriation:

Dividends

Blue Creek Ranch	$812.50
Murray Corp	499.80
Wallace-Murray Pfd	30.60
Cecil A. Blaffer Trust No. 1	128,793.00
Testamentary Trust for Sarah Campbell Blaffer	995,724.76
	1,125,860.66

Oil and gas royalties

Exxon Corp	5,932.37
Amoco Production	600.22
Scurlock Oil & Gas	59.63
Miscellaneous	2,785.05
	9,377.27

Rent income

Beekman Gallery, Inc	28,000.00

The tax on the dividend income, including the income received by petitioner from the distributions from Trust No. 1 and the Testamentary Trust listed on the Form 1040NR was computed using the 15-percent rate applicable under Article 9 of the Convention with the French Republic with Respect to Income and Property, July 28, 1967, 23 U.S.T. 20, T.I.A.S. No. 7270, effective January 1, 1967 (the French Tax Treaty), the income tax treaty between the United States and France. The tax on the remainder of petitioner's reported income was *771 computed at the flat 30-percent rate provided in section 871. Petitioner's total United States tax liability for 1975, as reported, was $341,998.

Petitioner did not file French income tax returns while she was a citizen of the United States. In reliance on the advice of her French accountants, she, likewise, did not file a French income tax return for the short period after her expatriation from December 23. 1975 through December 31, 1975. Petitioner did not pay any French income taxes on the 1975 trust distributions.

1976 AND 1977: Petitioner filed Forms 1040NR for 1976 and 1977, reporting income as follows:

	1976	1977
Dividends	$842,898	$591,388
Royalties	96,191	124,357
Director fees	200	200

Petitioner computed the United States tax with respect to this income under the applicable percentages set forth in the French Tax Treaty and section 871. During 1976, petitioner realized capital gains from the sale of various securities in the amount of $2,601,680. Under the provisions of Article 12 of the French Tax Treaty, capital gains, are not taxed. Accordingly, attached to the 1976 Form 1040NR is Schedule 4 entitled 'Gross Income Exclusion' which states the following:

For the year ended December 31, 1976, taxpayer has excluded: * * * capital gains in the amount of $2,601,680 received from the sale of personal property not used in a trade or business, pursuant to Internal Revenue Code Section 871 and Article 12 of the U.S. -French Tax Treaty * * *.

During 1977, petitioner realized capital gains, principally from the sale of her Exxon stock, in the amount of $7,225,295. As she did in her 1976 return, petitioner excluded the capital gains from income under Article 12 of the French Tax Treaty. She attached to her 1977 Form 1040NR Schedule 4 entitled 'Gross Income Exclusion' which states the following:

> For the year ended December 31, 1977, taxpayer has excluded: * * * capital gains in the amount of $7,225,295 received from the sale of personal property not used in a trade or business, pursuant to Internal Revenue Code Section 871 and Article 12 of the U.S. -French Tax Treaty.

*772 In 1976, petitioner's reported United States tax liability was $155,352; her French tax liability was $364,292. In 1977, petitioner's reported United States tax liability was $126,075; petitioner's French tax liability for the year was 1,628,897F.[9] Petitioner's 1975, 1976, and 1977 income tax returns were prepared by Arthur Young & Co., and she signed them as presented to her without question or change.

In the notice of deficiency, respondent determined that the principal purpose of petitioner's expatriation was the avoidance of United States income taxes, and relying upon section 877, determined the deficiencies set forth above by applying the graduated tax rates normally applicable to United States citizens with respect to petitioner's capital gains and United States source income received after the date of her expatriation.

OPINION

I. THE TAX AVOIDANCE ISSUE

Petitioner, a United States citizen by birth, adopted Austrian citizenship on December 23, 1975, thereby losing her United States citizenship. The controversy at hand centers on the income tax consequences flowing from petitioner's expatriation.

Until December 23, 1975, the date of her expatriation, petitioner reported her income and paid United States income taxes based on the graduated tax rates applicable to all United States citizens. Thereafter, as an Austrian citizen residing in Paris, petitioner became a nonresident alien for United States tax purposes. She reported her United States source income as a nonresident alien for the last week of 1975 (December 23-31) and for 1976 and 1977.[10] In her *773 nonresident alien returns (Forms 1040NR) for the periods at issue, petitioner reported that, as a nonresident alien resident in France, she was taxable under section 871 and the French Tax Treaty as follows:

1. She was subject to tax on her United States source dividends and interest at the respective rates of 15 percent and 10 percent under Articles 9 and 10 of the French Tax Treaty. Petitioner received substantial trust distributions in late 1975 which she reported on her 1975 nonresident alien return as dividends taxable at the 15 percent rate under the French Tax Treaty;

2. She was subject to tax on her other items of United States source income not covered by the treaty (royalties, rent, director's fees) at the flat rate of 30 percent under section 871; and

3. She was not subject to United States tax on her capital gains under Article 12 of the French Tax Treaty.

Respondent contends that the loss of petitioner's citizenship had for one of its principal purposes the avoidance of United States taxes so as to subject petitioner's United States source income and capital gains to taxation under the graduated tax rates made applicable by section 877 to former United States citizens who expatriate for tax avoidance purposes. Petitioner, in the first instance, urges us to resolve this factual issue in her favor by finding that tax avoidance was not one of her principal purposes in expatriating, thus finding her to be taxable as a nonresident alien under the more favorable rates prescribed by section 871 and the French Tax Treaty.[11]

Petitioner, however, raises an alternative legal issue as well. She contends that even were we to conclude that tax avoidance was one of her principal purposes in expatriating, she is, nevertheless, entitled, as a nonresident alien resident in France beginning December 23, 1975, to be taxed on her capital gains and United States source dividends and interest under the *774 French Tax Treaty.[12] Petitioner contends that because the French Tax Treaty and section 877 are inconsistent with respect to the rates of United States tax applicable to her, it is the French Tax Treaty, adopted subsequent to section 877, which takes precedence.[13] Respondent, however, takes the position that under Article 22(4)(a), the 'savings clause' of the French Tax Treaty, the benefits of the treaty are not available to former United States citizens who have lost their United States citizenship for tax avoidance purposes.[14] Because we resolve the factual issue in favor of petitioner, we find it unnecessary to decide the legal issue.

In general, section 877 provides that a nonresident alien individual who loses his United States citizenship shall be subject to tax on his United States source income, for the 10-year period following such loss, at the graduated tax rates applicable to United States citizens rather than more favorable rates applicable to nonresident aliens, unless the loss of citizenship did not have for one of its principal purposes the avoidance of United States taxes.[15] See *775 H. Rept. No. 1450, 89th Cong., 2d Sess., 1966-2 C.B. 967, 982 (1966); S. Rept. No. 1707, 89th Cong., 2d Sess., 1966-2 C.B. 1059, 1078 (1966). Section 877(e) specifically assigns the burden of proving the lack of a tax avoidance motive on the expatriate if respondent establishes that it is reasonable to believe that the individual's loss of United Sates citizenship would result in a substantial reduction in taxes. The parties have stipulated that respondent has met his initial burden of proof under section 877(e). Thus, the burden is on petitioner to demonstrate that tax avoidance was not one of her principal purposes in expatriating. The issue is purely factual.

Although we have never specifically interpreted the phrase 'one of its principal purposes' in the context of section 877, we find instructive the following definition set forth in Dittler Bros, Inc. v. Commissioner, 72 T.C. 896, 915 (1979), affd. without published opinion 642 F.2d 1211 (5th Cir. 1981), in which the Court was called upon to determine, under section 367, whether or not a certain translation was in 'pursuance of *776 a plan having as one of its principal purposes the avoidance of Federal income taxes:'

(W)e believe that the term 'principal purpose' should be construed in accordance with its ordinary meaning. Such a rule of statutory construction has been endorsed by the Supreme Court. Malat v. Riddell, 383 U.S. 569, 571 (1966). Webster's New Collegiate Dictionary defines 'principal' as 'first in rank, authority, importance, or degree.' Thus, the proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its 'first-in-importance' purposes the avoidance of Federal income taxes.

After careful consideration of all the evidence, we conclude that petitioner has carried her burden under section 877(e); we are convinced that petitioner did not have tax avoidance as one of her principal or 'first in importance' purposes in expatriating.

With respect to her intent in expatriating, petitioner testified that: She and Furstenberg decided to marry in early 1975. At that time, Furstenberg, a titled Austrian aristocrat, requested that petitioner adopt his Austrian citizenship. Although she had been living abroad for over 7 years, petitioner had never before considered expatriation. Desiring, however, to do what she could to make her third marriage a success and cognizant of the fact that it was general European custom for a wife to adopt the nationality of her husband, petitioner committed herself at the time of her decision to marry Furstenberg in early 1975 to 'bear his name, his title, and his nationality.'

Petitioner's decision to expatriate at the time of her marriage was further motivated, as she testified, by her ever-increasing, life-long ties to Europe; her preference for living in Europe rather than anywhere else; her personal and professional interest in the arts; the fact that, as of 1975, her social life was centered in Europe, where she had been living for over 7 years; and the fact that both of her parents were dead and her children were grown. In sum, her expatriation was the result of both her commitment to marry Furstenberg and the ultimate culmination of her life-long ties to Europe. Petitioner specifically declared that tax avoidance was neither a principal purpose, nor any purpose whatsoever, in her decision to adopt Austrian citizenship. We found petitioner to *777 be a straightforward and credible witness; we have no reason to disbelieve or doubt her testimony.

Respondent, citing cases dealing with determinations of fraud under section 6653(b), contends that intent, or the lack thereof, can seldom be established by direct proof and, therefore, urges us to examine petitioner's entire course of conduct to determine her intent in expatriating. It is true that in the context of a fraud determination, seldom will an individual be forthcoming with direct evidence of his fraudulent intent, and respondent, in order to carry his burden of proof, is often forced to present indirect evidence of the individual's conduct on which inferences as to fraudulent intent may be drawn. In this case, however, petitioner has the burden of proof, and she has squarely addressed the issue of her intent through her uncontroverted testimony. Moreover, an examination of petitioner's conduct with respect to her expatriation, in our view, only serves to corroborate her testimony concerning her lack of tax avoidance motives.

Petitioner met with her accountant, Gordon Moore, in late April or early May 1975, only after her decision to marry Furstenberg and her commitment to adopt Austrian citizenship had been made. She asked him to advise her concerning the income tax consequences of her planned marriage and expatriation. At that time, he warned petitioner that her plan to marry and expatriate would 'complicate' her taxes; that French taxes could be very bad and were getting worse. Petitioner had no further discussions with Moore until March 1976, after her expatriation, when he advised her of the risk of double taxation on her dividends by France and United States.

Only after this second meeting with Moore, which occurred after her expatriation, did petitioner decide to sell the bulk of the securities that she received in the 1975 distribution from the Testamentary Trust. Sales of those securities resulted in substantial capital gains in 1976 and 1977. Indeed, she did not sell her Exxon stock, a valuable family asset, until 1977. That she sold her Exxon stock at all, against her mother's express advice, is striking evidence that petitioner's sales of securities stemmed from her concern with respect to double taxation on *778 her dividends after her expatriation rather than any preconceived plan of tax avoidance. [16]

The foregoing chronology of events makes clear that at the time of her expatriation, petitioner was aware not of any possible tax advantages, but only of possible negative tax consequences which could follow from giving up her

United States citizenship. Petitioner's decision to sell her securities was made after her expatriation. Avoidance of taxes, therefore, could not have been a consideration either as of the date of her decision to expatriate or the date of expatriation itself.

Further, rather than concluding that the timing of petitioner's expatriation points to her tax avoidance motives, as urged by respondent, we think the timing of her expatriation is compelling evidence itself that petitioner's expatriation was inextricably linked only to her commitment to marry Furstenberg, rather than to any plan of tax avoidance. Petitioner expatriated on December 23, 1975, only 4 days following her return from her honeymoon and the day of her scheduled departure for a Christmas holiday in Italy. Had her expatriation not been tied to her marriage to Furstenberg, petitioner, who had been living in Europe for over 7 years and in France for at least 5 years, could have expatriated years earlier. She could have, thereby, claimed the benefits of the French Tax Treaty years earlier.

In addition, knowing that she was eventually to receive sizeable trust distributions, petitioner, were she as sophisticated a taxpayer as respondent would have us believe, could surely have coordinated the timing of her expatriation viz-a-viz the trust distributions more favorably. She could have expatriated before both trust distributions. Surely petitioner would not have given her son the power of attorney and receipt and release authorizing him to receive her trust distribution at any particular time. By the terms of Trust No. 1, she was legally entitled to quarterly distributions, beginning on January 1, 1976, after her December 17, 1975, birthday; yet she did nothing to cause the trustee to vary its administrative *779 practice of distributing shortly after her December birthday the full amount to which she was entitled for the succeeding year. The timing of the November 1975 distribution from the Testamentary Trust was within the control of her sister as trustee; yet petitioner did nothing to delay the distribution so that it would be received in the taxable year after her expatriation was complete.

The timing of these trust distributions, which appear to have been made in the routine course of business, corroborates petitioner's testimony that she did no planning with respect to, and was not even aware of, the timing of the distributions. That she did no planning with respect to the trust distributions is evidence of her lack of tax avoidance motives in giving up her United States citizenship. In our view, none of petitioner's actions, or her omissions to act, were done with tax avoidance as a first-in-importance purpose.

Petitioner's actions here are clearly distinguishable from those of Max Kronenberg, the taxpayer in Kronenberg v. Commissioner, 64 T.C. 428 (1975), the only other case in which the Court has decided the issue of tax avoidance as a principal purpose in expatriation under sec. 877. Kronenberg was a naturalized United States citizen who had retained his Swiss citizenship. From 1955 through 1966, Kronenberg owned 95.30 percent of the outstanding stock and was the president and co-director, with his wife, of PIC, Inc., a mica importing business. In 1966, Kronenberg decided to sell the business and considered moving back to Switzerland. On Feb. 26, 1966, PIC's shareholders voted to effect a complete liquidation under sec. 337 to be completed by Feb. 25, 1967. In Dec. 1966, Kronenberg learned from his accountant that if he lost his United States citizenship prior to receiving the liquidating distribution from PIC, Inc., it would not be subject to tax by the United States. The Court described Kronenberg's subsequent activities as follows (64 T.C. at 434-435):

> After learning of such tax advantage, he engaged in a flurry of activity: he engaged attorneys to prepare the papers and complete the liquidation of PIC; he sold the family house; he made all the necessary arrangements for the transportation of his family and possessions to Switzerland; on February 20, 1967, the shareholders and directors of PIC met and took the necessary actions to complete the liquidation of the corporation; he instructed his attorneys to distribute to him all the assets of PIC at the latest possible time; he and his family actually left the United States on February 21, 1967, and *780 arrived in Zurich on the following day; on February 23, 1967, he and his wife renounced their U.S. citizenship; and in accordance with his instructions, the transfer of funds from PIC to his personal account was carried out by his attorneys on February 24, 1967.

Finding Kronenberg's activities of Jan. and Feb. 1967 'too perfect to be unplanned,' (supra at 435) the Court concluded that the evidence failed to show that Kronenberg gave any consideration to renouncing his United States citizenship before he learned of the tax advantages of doing so. The Court was 'compelled' to find that Kronenberg had expatriated for tax avoidance purposes.

In contrast, petitioner's activities were too imperfect from a tax standpoint to have been planned. As we have discussed, petitioner engaged in no 'flurry of activity' in connection with her expatriation. She decided to expatriate before she knew anything about the tax consequences thereof; she had lived in Europe for over 7 years; at the time of her expatriation she knew of only possible negative tax effects; and her activity, or lack of it, viz-a-viz the trust distributions indicates that she did no planning whatsoever to delay them until after her expatriation.

Respondent has offered no evidence to refute or impeach petitioner's testimony concerning her motives for expatriating. He urges us, however, to infer a tax avoidance motive because petitioner never resided in Austria after adopting Austrian citizenship; because of the 'fortunate' timing of her expatriation concommitant with the Testamentary Trust distribution of various securities, in 1976 and 1977, resulting in the realization of substantial capital gains which, but for her expatriation, enabled petitioner to reap significant tax benefits; and because petitioner is a wealthy, intelligent woman who in the past had relied on tax counsel. [17] This we decline to do.

First, we do not find as troubling as does respondent the fact that petitioner never resided in Austria after adopting Austrian citizenship. It merely corroborates petitioner's testimony ***781** that she adopted the Austrian citizenship of her husband as part of her marriage commitment, and reflects her belief that she was conforming to the custom of the European aristocracy which she was entering by her marriage. Petitioner testified that she was not adverse to living in Austria; indeed, she spent over a month there in the summer of 1975, staying at Furstenberg's hunting lodge in Strobl. We think it quite reasonable, nonetheless, for petitioner and Furstenberg to have settled in Paris after their marriage. Furstenberg, who was 71 years old at the time of the marriage, had himself been living outside of Austria for many years, and he did not like living in Austria's harsh climate. Petitioner had lived in her Paris apartment for 5 years and was obviously settled into the social life there. That they chose to live in Paris rather than Austria, therefore, raises no suspicion of tax avoidance motives.

Further, we draw no negative inference from the timing of the Testamentary Trust distribution in light of petitioner's uncontroverted testimony that at the time of her expatriation she had no intention of selling any of the securities distributed. The record is clear that only after her meeting with her accountant in March 1976, after her expatriation, did she decide to sell the securities out of her concern with respect to the possibility of double taxation of her dividends. Moreover, as we have discussed, had tax considerations played an important role in her decisions, she could have caused the trust distributions to have been more favorably timed.

Finally, although it is true that petitioner is a wealthy and intelligent woman, she has no more than a layman's knowledge of the tax law; indeed, she admitted that she did not read or understand her tax returns for the years at issue, she merely signed what was presented to her by her accountants. Thus, we cannot infer a tax avoidance motive merely by virtue of her wealth and intelligence.

Petitioner, in this case, has had the burden of proving a negative, i.e., a lack of intent. Admittedly, this is usually a difficult thing to do. She testified that tax avoidance was not a purpose in her expatriation; her actions and the surrounding circumstances support her testimony. There is no evidence other than the magnitude of the deficiencies here in dispute to suggest otherwise. Although those deficiencies are sufficient to ***782** place the burden of proof on petitioner under section 877(e), they are not enough to refute the direct credible testimony presented by petitioner and the corroborating facts and circumstances. We think petitioner has adequately met her burden of proving a lack of tax avoidance motives. Thus, we conclude that because tax avoidance was not one of petitioner's principal purposes in expatriating, she is not taxable under section 877.

2. TAXABILITY OF THE 1975 TRUST DISTRIBUTIONS

Having decided above that, after her expatriation, petitioner is not taxable under section 877, but rather, under section 871 and the French Tax Treaty, we turn to the alternative issues raised by respondent with respect to the proper tax rates applicable to the two trust distributions received by petitioner in 1975.

On November 20, 1975, petitioner received a distribution of $995,724.76 from the Testamentary Trust, a complex trust with a taxable year ending December 31, consisting of distributable net income in the amount of $164,971.63 and an accumulation distribution in the amount of $830,753.13. In December 1975, petitioner received a distribution consisting entirely of distributable net income in the amount of $128,792.71 from Trust No. 1, also a complex trust, with a taxable year ending December 31. Petitioner reported both trust distributions on her 1975 Form 1040NR as dividend income received after December 23, 1975, the date of her expatriation, and taxable at the flat rate of 15 percent under Article 9 of the French Tax Treaty.

Respondent contends that petitioner was in actual receipt of the accumulation distribution from the Testamentary Trust and in constructive receipt of the distribution from Trust No. 1 before the date of her expatriation, and, therefore, both distributions are taxable at the graduated tax rates applicable to petitioner for the period of 1975 during which she was still a United States citizen.[18] We shall discuss the taxability of each of the trust distributions in turn.

*783 A. THE TESTAMENTARY TRUST

The parties have stipulated that on November 20, 1975, before her expatriation, petitioner received a distribution from the Testamentary Trust, a portion of which was distributable net income and the balance was an accumulation distribution. Although she actually received the distribution before her expatriation, petitioner reported it on her 1975 Form 1040NR as taxable during the short period after she had become a nonresident alien. On brief, petitioner concedes that the portion of the distribution consisting of distributable net income ($164,971.63), is taxable at the graduated rates applicable to her while she was still a United States citizen. Petitioner maintains, however, that, regardless of the timing of the actual receipt, the accumulation distribution ($830,753.13) should, under section 668(a) and 662(c), in the form in which they were then in effect, be includible in income during the period after which she lost her United States citizenship.

For the reasons stated below, we conclude that sections 668(a) and 662(c) do not require the result urged by petitioner; we sustain respondent's determination that the entire amount of the Testamentary Trust distribution is includible in income during the period before petitioner lost her United States citizenship and is thus taxable at the usual graduated rates.

Section 668(a), as in effect in 1975, provides that accumulation distributions from complex trusts 'shall be included in the income of a beneficiary of the trust when paid.'[19] Amplification *784 of this statutory directive is found in section 1.668(a)-1A(a), Income Tax Regs., which provides that the total of an accumulation distribution is to be included in the income of the beneficiary in the taxable year of the beneficiary in which such amounts are in fact paid unless the taxable year of the beneficiary differs from the taxable year of the trust. In such a case, the regulation directs us to the rules under section 662(c), which provides that when a beneficiary has a taxable year different from that of the trust, an accumulation distribution is to be included in income in the tax year of the beneficiary which coincides with, or encompasses, the end of the tax year of the trust.[20] Petitioner contends that by virtue of her loss of United States citizenship, 'a distinctive situation arose which required the operation of section 662(c) ' with respect to the timing of inclusion of the accumulation distribution.

Petitioner argues that, because of her change in status from United States citizen to nonresident alien, she had two taxable years during 1975, the first covering her period of United States citizenship through December 22, and the second commencing December 23, the date of her expatriation, and ending December 31, covering the period during which she had become a nonresident alien. Petitioner's argument is based on the interaction of (1) section 1.871-13(a)(1), Income Tax Regs., which provides that when a taxpayer changes status from United States citizen to *785 nonresident alien during the taxable year, he is taxable for such year 'as though his taxable year were comprised of two separate periods,' the first covering income received as a United States citizen and the second covering income received as a nonresident alien; (2) section 1.662(c)-1, Income Tax Regs., which provides that section 662(c) 'applies to so-called short taxable years as well as taxable years of normal duration'; and (3) section 441(b)(3) which defines the term 'taxable year' as 'the period for which the return is made, if a return is made for a period of less than 12 months.' She maintains that, because section 441(b)(3) defines 'taxable year' in terms of 'periods,' sec. 1.871-13(a)(1), Income Tax Regs., which divides the taxable year into 'periods,' sanctions the existence of two taxable years in a change-of-status calendar year.

Petitioner thus argues, because she had two taxable years in 1975 which were different from those of the Testamentary Trust, section 662(c) requires the inclusion of the accumulation distribution in her taxable income during her short nonresident alien status taxable year, the end of which coincides with the end of the trust's taxable year. In effect, petitioner seeks to have us equate the notion of a 'taxable period' with that of a short 'taxable year.'

We agree with respondent that petitioner's position calls for a misapplication of section 1.871-13(a)(1), Income Tax Regs., and section 441(b)(3). Petitioner's argument fails because, although her change-of-status year is bifurcated with respect to the tax rates applicable to income received during the period of citizenship versus nonresident alien status, her taxable year remains a single calendar year taxable year; her change of status does not create a short taxable year within the definition of section 443(b)(3). Because petitioner and the Testamentary Trust both have the same taxable year, section 662(c) is, by its terms inapplicable to petitioner.

Section 1.871-13(a)(1), Income Tax Regs., directs a status changing taxpayer to treat his taxable year 'as though' it were 'comprised of two separate periods.'[21] By its express *786 terms, the regulation provides that a status changing taxpayer will have only one taxable year, albeit one which is divided into two portions, each taxable at different rates. Consistent with the notion that only a single taxable year is involved in a change-in-status situation, sec. 1.6012-1(b)(2)(ii), Income Tax Regs., provides that only one tax return should be filed for a dual status year, the proper form of which is determined by the status of the taxpayer at the taxable year-end, with allocations between the two periods reflected on a separate schedule attached to the return.[22] In compliance with this regulation, petitioner herself filed only one tax return for 1975, a Form 1040NR, attaching the required schedule of income allocations between the two periods.

We do not think that the definition of the term 'taxable year' in section 441(b)(3) in any way transforms the two periods described in section 1.871-13(a)(1), Income Tax Regs., into two separate taxable years. Under section 441(b)(3), a period of less than 12 months is defined as a taxable year only if a return is made for a period of less than 12 months.[23] Sec. 1.441-1(b)(iii), Income Tax Regs., further directs that a return for a period of less than 12 months must be made under the provisions of section 443. As it then stood, section 443(a) authorized such 'short period' returns under only three specific circumstances: (1) When a taxpayer changes his annual accounting period; (2) when a taxpayer is not in existence for an entire taxable year; and (3) when the Secretary terminates a taxpayer's taxable year for jeopardy. Petitioner has not argued, nor could she, that her circumstances conform to those specified in section 443; in fact as stated above, she filed a single return for a 12-month calendar year year. Section 441(b)(3) is, thus, inapplicable to her 1975 return.

*787 Our conclusion that a status changing taxpayer has only a single taxable year in the year of change finds support in the reasoning of Estate of Petschek v. Commissioner, 81 T.C. 260 (1983), affd. 738 F.2d 67 (2d Cir. 1984). Petschek, a calendar year taxpayer, was the income beneficiary of a simple trust, which also reported its income on a calendar year basis. During 1975, the year at issue, Petschek was a United States citizen until November 23, 1975, when he became a citizen of France. The issue was whether distributions from the trust should be taxed at the rates applicable to United States citizens or to nonresident aliens.

This Court observed in Estate of Petschek, 81 T.C. at 264 n. 6, that the two periods prescribed in the case of status changing taxpayers by sec. 1.871-13(a)(1), Income Tax Regs., 'are not separate taxable years.' Further, in addressing Petschek's argument under section 652(c), which, as does section 662(c) in the case of complex trusts, prescribes the timing of inclusion in income of distributions from simple trusts when the beneficiary and the trust have different taxable years, the Court noted: 'The case before us does not involve such different taxable years.' 81 T.C. at 270.[24] In affirming this Court's opinion on this point, the court of appeals (738 F.2d at 72) explained that 'the operation of section 652(c) presupposes the continuation of the beneficiary's and the trust's respective taxpayer statuses from year to year' and stated that 'Petschek's tax year did not end with his abandonment of his citizenship.' With respect to the issue of whether a change in status creates two taxable years for a dual status taxpayer, we see nothing to distinguish the facts of the instant situation from those of Estate of Petschek even though we are here dealing with a complex trust. Thus, as section 652(c) was inapplicable to Estate of Petschek, so too is section 662(c) inapplicable to petitioner.

Having so decided, however, the issue remains as to the proper period for inclusion of the accumulation distribution under sec. 1.871-13(a)(1), Income Tax Regs., given the practical ***788** reality that, in the usual case, the amount of an accumulation distribution is calculated as of the end of the trust year. In Estate of Petschek, we rejected the taxpayer's argument that because distributable net income from a simple trust is calculated at the end of the trust's taxable year, such amount may only be included in the income of the beneficiary on the last day of the taxable year. There we held that a beneficiary of a simple trust, i.e., one which is required to distribute all income currently, earns income simultaneously with the trust's realization of income, and, therefore, he must include in his own income for the period while he was still a United States citizen all of the income earned by the trust during that period regardless of whether it had yet been distributed to him. In Estate of Petschek, however, we declined to decide how distributions from a complex trust, which could include income accumulated over a period of years, would be taxed. The statutory scheme governing complex trust distributions makes no special provision for the unique considerations involving change-in-status taxpayers; thus, the statute does not provide us with specific guidance on this issue.

Petitioner is correct in her assertion that the conduit rationale underlying our Estate of Petschek decision, based as it is on legal principles governing only simple trusts, may be inapplicable to an accumulation distribution from a complex trust. Such a distribution represents amounts that were earned by the trust in prior years and taxed at trust rates usually lower than rates applicable to the beneficiary's income. Such amounts, therefore, are not earned by the beneficiary simultaneously with the trust. We do not agree, however, that the reasoning of Estate of Petschek is wholly irrelevant to the issue before us. Estate of Petschek, as well as other cases cited by respondent, supports our conclusion that the taxation of change-of-status taxpayers is not always to be governed by the automatic application of the 'usual' rules.[25]

***789** On the facts of this case, because the accumulation distribution was actually received by petitioner and available for her use and benefit before her expatriation, we think it is includible in her income for the period in 1975 during which she was a United States citizen and thus taxable at graduated United States tax rates. This conclusion is consistent with both the literal terms of section 668(a) which directs inclusion of an accumulation distribution in the income of a beneficiary 'when paid,' and the directive of section 666(a)[26] that the amount of the accumulation distribution shall be deemed to be an amount 'distributed on the last day of each of the preceding taxable years' for which the undistributed income was accumulated. These provisions indicate that consideration of the beneficiary's status both at the time of distribution and during the years of income accumulation is relevant in determining the tax consequences of an accumulation distribution to a status-changing taxpayer.[27]

Under the circumstances of this case, because petitioner was a United States citizen both during the years of accumulation and at the time of distribution, we think section 668 calls for the tax to be applied to such distribution at rates applicable to United States citizens. Certainly, to do so is consistent with the general policy underlying the taxation of accumulation distributions under the 'throwback rules' of section 666, i.e., to eliminate tax avoidance by ensuring that a trust beneficiary pays tax at the rates applicable to him on the trust distributions he receives, rather than allowing him by income accumulation to shift the tax burden to the trust which is subject, generally, to lower tax rates. See H. Rept. No. 1337, 83d Cong., 2d Sess., 60-64; S. Rept. No. 1622, 83d Cong., 2d Sess., 84-85 (1954).

Admittedly, our conclusion is made easier by the fact that the amounts of distributable net income and accumulated income stipulated by the parties as having been received by ***790** petitioner before her expatriation constitute the entire year's trust income as revealed by the 1975 Form 1041 fiduciary return for the Testamentary Trust. There is, therefore, no problem in allocating current earnings during 1975 between petitioner's citizen and nonresident alien periods. Such accounting problems need not be addressed here. We emphasize that we are not announcing a hard and fast rule with respect to the timing of income inclusion of an accumulation distribution by a change-of-status taxpayer. On the facts of this case, however, we think the accumulation distribution is includible in petitioner's income for the period during which she was a United States citizen.

B. TRUST NO. 1

On December 17, 1975, petitioner attained the age of 56 years and under the terms of Section II of the instrument governing Trust No. 1, she became entitled to receive a distribution of $^1/_9$ of the principal of the trust. Although the trust instrument provided that payment of the distribution calculated as of December 17, 1975, was to be made in quarterly installments beginning on January 1, 1976, the year following petitioner's 1975 birthday, the trustee, Texas Commerce Bank, had for years followed the administrative practice of calculating the amount of each year's distribution as of December 17, the petitioner's birthday, and paying the entire amount of that year's distribution in a single annual payment on some date following petitioner's birthday, often, but not always in the same year on which the calculated amount was based.

With respect to the 1975 distribution at issue, the facts, undisputed by the parties, are as follows: The amount of the distribution was calculated based on the value of the trust assets as of December 17, 1975, petitioner's birthday. Petitioner returned to Europe on December 19, 1975. The trustee's check for the distribution was written on December 22, 1975, and recorded on the trustee's books on December 23, 1975. The check was deposited into petitioner's account on December 23, 1975. The trust officer in charge of Trust No. 1 could not remember whether he personally delivered the check to petitioner's family office on December 22, or whether he placed it in the mail.

***791** There is no evidence that petitioner or her agent actually received the check before December 23, 1975, the date it was deposited in petitioner's account.[28] Thus, the issue is whether she constructively received the income before that date.[29] This issue was raised by respondent for the first time in his Answer and Answer to Amended Petition; the issue is, therefore, a new matter with respect to which respondent has the burden of proof. Rule 142(a); Achiro v. Commissioner, 77 T.C. 881, 890 (1981); Estate of Falese v. Commissioner, 58 T.C. 895, 898-899 (1972). Our study of the evidence on this issue leads us to conclude that respondent has failed to meet his burden; on the evidence before us, we are unable to find that petitioner was in constructive receipt of the distribution from Trust No. 1 before December 23, 1975.

The doctrine of constructive receipt is based on the principle that income is received by cash method taxpayers 'when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession.' Loose v. United States, 74 F.2d 147, 150 (8th Cir. 1934). The general rule with respect to the inclusion of income under the doctrine of constructive receipt is set forth in section 1.451-2(a), Income Tax Regs., as follows:

Sec. 1.451-2. Constructive receipt of income.

(a) General rule. Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. * * *

Respondent bases his contention that petitioner was in constructive receipt of the distribution before her expatriation ***792** on the following evidence: The amount of the distribution was calculated by the trustee 'as of' December 17, 1975; the check was written on December 22, 1975; according to Lewis, the trust officer responsible for the administration of Trust No. 1, petitioner or her agent could have picked up the check the day it was written; further, according to Lewis, had petitioner so requested he could have made the distribution as early as December 19, 1975 These facts, argues respondent, demonstrate that the distribution was made available to petitioner so that she could have draw upon it before her expatriation if notice of her intention withdraw had been given.

We do not think that the evidence on which respondent relies is sufficient to demonstrate constructive receipt in this case. Implicit in the notion of availability to the taxpayer is notice to him that the funds are subject to his will and control.[30] Respondent has failed to show that either petitioner or her agent was informed or knew that the distribution check could have been picked up on December 22, 1975, or that they could have requested an earlier distribution.

Our findings reveal that the yearly distributions from 1970 through 1976 were not made on any specific date; in only 2 of 7 years, 1972 and 1974, was the distribution recorded before December 23; in 2 years, 1971 and 1975, it was recorded on that date. Thus, petitioner could have had no expectation that she would receive the check before her expatriation. Petitioner, in fact, never communicated with the trustee with respect to any of the yearly trust distributions. It is true that petitioner's agent, Mrs. Howton, did, from time to time, communicate with the trustee concerning distributions from Trust No. 1; however, there is no evidence that Mrs. Howton ever communicated with the trustee with respect to the timing of such distributions, or that she had any knowledge that she could influence the timing.

This is clearly not a case in which petitioner 'turned her back' on the income by taking any affirmative steps to delay receipt of the check until after her expatriation. Compare Romine v. Commissioner, 25 T.C. 859, 873-875 (1956). As discussed in Part 1, above, petitioner did no planning whatsoever with respect to the Trust No. 1 distribution. Mindful of *793 the oft-stated principle that constructive receipt should be sparingly applied, Kaw Dehydrating Co. v. Commissioner, 74 T.C. 370, 375 (1980); Gullett v. Commissioner, 31 B.T.A. 1067, 1069 (1935), we do not think petitioner can be charged with constructive receipt of the trust distribution based on speculation concerning whether the trustee would have agreed to an earlier payment if so requested.[31] See Amend v. Commissioner, 13 T.C. 178, 184-185 (1949).

Thus, we conclude that petitioner was not in constructive receipt before her expatriation of the distribution from Trust No. 1 and that she properly reported the distribution as received during the period of 1975 in which she was a nonresident alien. The distribution from Trust No. 1 is taxable as reported by petitioner.

Based on the foregoing,

Decision will be entered under Rule 155.

All Citations

83 T.C. No. 43, 83 T.C. 755, Tax Ct. Rep. (CCH) 41,633

Footnotes

1 All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

2 The parties have stipulated an actual distribution to petitioner on Nov. 20, 1975, before petitioner's expatriation, from the Testamentary Trust in the amount of $995,724.76. Such distribution consisted of $164,971.63 in distributable net income and $830,753.13 in accumulated income. Petitioner concedes that the portion of the distribution consisting of distributable net income actually received before her expatriation is taxable at the normal graduated rates applicable to United States citizens; at issue here is only the portion consisting of the accumulation distribution.

3 Petitioner owned a substantial portion of the stock of Societe Immobiliere Commerciale et Agricole (S.I.C.A.), a French corporation. S.I.C.A. was in the business of selling lots which it owned at St. Paul de Vence in the south of France. Petitioner planned for S.I.C.A. to sell all of its lots but one on which she and Sheridan would build a home and live.

4 As a child, petitioner was encouraged by her mother to study the fine arts; petitioner's mother made lifetime gifts to her of paintings by such artists as Matisse, Braque, and Picasso. Further, petitioner's corporation, Beekman Gallery Corporation, which was operated by petitioner with an associate, had been engaged in the business of buying and selling art objects all over the world for approximately 20 years. The fact that petitioner lived in Europe was advantageous in her work for the corporation, because there were more art markets in Europe than in the United States.

5 Petitioner and Furstenberg did, however, visit the lodge and spend time there during the summer months. During July, Aug., and Sept. 1975, they spent 4 to 6 weeks in Austria to visit Furstenberg's family and friends and spend time at the lodge.

6 None of petitioner's great-grandparents was born in the United States. On her father's side of the family, petitioner had two German great-grandparents, a French Huguenot-Alsatian grandfather and an Austrian great-grandmother. Petitioner's maternal great-grandparents were all born in Scotland.

7 As described more fully, infra, petitioner sold securities in 1976 and 1977, realizing significant capital gains. Most of the securities sold by petitioner were distributed to her upon the death of petitioner's mother. At the time of petitioner's meeting with Moore, petitioner's mother had not yet died.

8 Petitioner's mother established the Sarah Campbell Blaffer Foundation to which she contributed many works of art and also funds so the foundation could add to its collection. The foundation operates a teaching art collection which is shown in schools throughout Texas. Petitioner is a trustee of the foundation.

9 The only evidence in the record concerning petitioner's French tax liability for 1977 is her 1977 French tax return on which her tax liability was reported in French francs.

10 Sec. 1871-13(a), Income Tax Regs., requires that when an individual changes his status from United States citizen to nonresident alien during the taxable year, the individual is taxable as though his taxable year were composed of two separate periods.

During the first period of United States citizen status, the individual is taxable under the rules generally applicable to United States citizens, i.e., he is taxable on his worldwide income at the customary graduated tax rates. Cook v. Tait, 265 U.S. 47 (1924); Filler v. Commissioner, 74 T.C. 406, 410 (1980); sec. 1.1-1(b), Income Tax Regs.

During the second period of nonresident alien status, commencing on the date United States citizenship is renounced, the individual is taxable under the special rules applicable to nonresident aliens, i.e., in general, he is taxed either, under sec. 871, at a flat 30-percent rate only on gross income derived from sources within the United States or gross income which is effectively connected with the conduct of a trade or business within the United States, or, under sec. 894, at lower treaty rates, where applicable.

Sec. 1.6012-1(b)(2)(ii)(b), Income Tax Regs., provides that only one tax return should be filed for a dual status year with allocations reflected on a special schedule attached to the return; the proper form is determined by the status of the taxpayer at taxable year-end. Thus, for 1975, the year of her change in status, petitioner filed a Form l040NR, a nonresident alien return.

See discussion, infra, in Part 2, A, concerning the issue of whether a change in status creates 2 taxable years.

11 Assuming that the principal purpose of her expatriation was not tax avoidance, the parties have stipulated to a11 of the conditions necessary for the application of Articles 9, 10, and 12 of the French Tax Treaty to petitioner's capital gains and United States source dividends and interest.

12 Petitioner concedes on this issue that should we find tax avoidance a principal purpose in her expatriation, the remainder of her United States source income is taxable under sec. 877.

13 Sec. 877 was added to the Internal Revenue Code of 1954, as amended, by H.R. 13103, 90th Cong., lst Sess. (1966), the Foreign Investors Tax Act of 1966, Pub. L. 89-809, 80 Stat. 1541, signed into law by the President on Nov. 13, 1966. The French Tax Treaty, 19 U.S.T. 5280, T.I.A.A. 6518, effective during the years at issue was signed July 28, 1967; the United States Senate gave its advice and consent to ratification of the Treaty on June 6, 1968; it was brought into force by an exchange of instruments of ratification on July 11, 1968.

14 During the years at issue, Article 22(4)(a) of the French Tax Treaty, known as the 'savings clause,' provided as follows:

The United States may tax its citizens and residents as if the present Convention had not come into effect.

By a Protocol to the French Tax Treaty, 1979-2 C.B. 411, 413, T.I.A.S. No. 8500, signed Nov. 24, 1978, in force Oct. 27, 1979, by exchange of instruments of ratification and effective for tax years beginning on or after Jan. 1, 1979, the savings clause of the French Tax Treaty was changed to read as follows:

The United States may tax its citizens and residents as if the present Convention had not come into effect. For this purpose the term 'citizen' shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss.

Respondent contends, as detailed more fully in Rev. Rul. 79-152, 79-1 C.B. 237, that this change was a 'clarifying change' only and that, even though the French Tax Treaty did not, during the years at issue, specifically reserve the right of the United States to tax under sec. 877, petitioner is nonetheless subject to tax under that section.

15 SEC. 877. EXPATRIATION TO AVOID TAX.

(a) In General—Every nonresident alien individual who at any time after March 8, 1965, and within the 10-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

(b) Alternative Tax.—A nonresident alien individual described in subsection (a) shall be taxable for the taxable year as provided in section 1, 55, or 402(e)(1), except that,

(1) the gross income shall include only the gross income described in section 872(a) (as modified by subsection (c) of this section), and

(2) the deductions shall be allowed if and to the extent that they are connected with the gross income included under this section, except that the capital loss carryover provided by section 1212(b) shall not be allowed; and the proper allocation and apportionment of the deductions for this purpose shall be determined as provided under regulations prescribed by the Secretary.

For purposes of paragraph (2), the deductions allowed by section 873(b) shall be allowed; and the deduction (for losses not connected with the trade or business if incurred in translations entered into for profit) allowed by section 165(c)(2) shall be allowed, but only if the profit, if such transaction had resulted in a profit, would be included in gross income under this section.

(c) Special Rules of Source.—For purposes of subsection (b), the following items of gross income shall be treated as income from sources within the United States:

(1) Sale of property.—Gains on the sale or exchange of property (other than stock or debt obligations) located in the United States.

(2) Stock or debt obligations.—Gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of United States persons of the United States, a State or political subdivision thereof, or the District of Columbia.

(d) Exception for Loss of Citizenship for Certain Clauses.—Subsection (a) shall not apply to a nonresident alien individual whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

(e) Burden of Proof.—If the Secretary establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction for the taxable year in the taxes on his probable income for such year, the burden of proving for such taxable year that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B shall be on such individual.

16 According to the testimony of a French tax law expert, if petitioner's dividend income were to be taxed by the United States under sec. 877, the aggregate marginal rate of tax on her dividends would be 115 percent, 70 percent to the United States and 45 percent to France. Because most of petitioner's income was derived from United States sources, her sec. 901 foreign tax credit would be minimal.

17 We will not draw any negative inference against petitioner, as urged by respondent, as a result of petitioner's assertion of the attorney-client privilege in these proceedings. See 8 Wigmore, Evidence, sec. 2322 at 630 (1961): 'If a client party claims the (attorney-client) privilege, the prevailing view * * * is that no inference should be drawn against him as to the unfavorable nature of the information sought.'

18 petitoner was a United States citizen on Dec. 22, 1975, but became an alien for the entire day of Dec. 23, 1975, the date of her expatriation. Sec. 1.871-13(a)(2), Income Tax Regs; Estate of Petschek v. Commissioner, 81 T.C. 260, 264 (1983), affd. 738 F.2d 67 (2d Cir. 1984).

19 SEC. 668. TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PRECEDING YEARS>

(a) General Rule.—The total of the amounts which are treated under sections 666 and 669 as having been distributed by the trust in a preceding taxable year shall be included in the income of a beneficiary of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary under section 662(a)(2) and (b) if such total had been paid to such beneficiary on the last day of such preceding taxable year. * * *

Sec. 662(a), here referred to, is in pertinent part as follows:

SEC. 662. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS.

(a) Inclusion.—Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in section 661(a) is paid, credited, or required to be distributed (by an estate or trust described in section 661), the sum of the following amounts:

(1) Amounts required to be distributed currently.—The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. * * *

(2) Other amounts distributed.—All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. If the sum of,

(A) the amount of income for the taxable year required to be distributed currently to all beneficiaries, and

(B) all other amounts properly paid, credited, or required to be distributed to all beneficiaries

exceeds the distributable net income of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (reduced by the amounts specified in (A)) as the other amounts properly paid, credited or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

20 SEC. 662. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS.

(c) Different Taxable Years.—If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

The implementing regulation provides in part:

Sec. 1.662(c)-1. Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of an estate or trust, the amount he is required to include in gross income in accordance with section 662(a) and (b) is based upon the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust ending with or within his taxable year. * * *

21 Sec. 1.871-13. Taxation of individuals for taxable year of change of U.S. citizenship or residence.

(a) In general. (1) An individual who is a citizen or resident of the United States at the beginning of the taxable year but a nonresident alien at the end of the taxable year, or a nonresident alien at the beginning of the taxable year but a citizen or resident of the United States at the end of the taxable year, is taxable for such year as though his taxable year were comprised of two separate periods, one consisting of the the time during which he is a citizen or resident of the United States and the other consisting of the time during which he is not a citizen or resident of the United States. * * *

22 This regulation embodies respondent's longstanding policy of requiring only one return for a dual status taxpayer dating back to G.C.M. 10759, XI-2 C.B. 99 (1932).

23 SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

(b) Taxable Year.—For purposes of this subtitle, the term 'taxable year' means,

(3) the period for which the return is made, if a return is made for a period of less than 12 months; * * *

24 See also Nico v. Commissioner, 565 F.2d 1234, 1236 (2d Cir. 1977), affg. in part and revg. in part 67 T.C. 647 (1977); More v. Commissioner, 66 T.C. 27 (1976), affd. without published opinion 562 F.2d 38 (2d Cir. 1977); Simenon v. Commissioner, 44 T.C. 820, 832-833 (1965); Klaas v. Commissioner, 36 T.C. 239 (1961). These cases all hold, in the context of various Code sections, that a change in status does not provide a dual status taxpayer with a short taxable year.

25 Illustrative of this principle are Marsman v. Commissioner, 205 F.2d 335 (4th Cir. 1953), affg. in part and revg. and remanding in part 18 T.C. 1 (1952), and Gutierrez v. Commissioner, 53 T.C. 394 (1969), affd. per curiam without published opinion (D.C. Cir. 1971). In those cases it was held, in spite of the unambiguous statutory directive under sec. 551(b) and its predecessor sec. 337(b), I.R.C. 1939, that the full amount of a deemed dividend from a foreign personal holding company is to be included in the shareholder's income as of the last day of the year, that only a pro rata portion of the dividend should be taxed to the taxpayers therein reflecting the fact that they had only been resident aliens for the last portion of the year, and subject to United States tax for only such portion.

26 SEC. 666. ACCUMULATION DISTRIBUTION ALLOCATED TO PRECEDING YEARS.

(a) Amount Allocated.—In the case of a trust which is subject to subpart C, the amount of the accumulation distribution of such trust for a taxable year shall be deemed to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of each of the preceding taxable years, commencing with the earliest of such years, to the extent that such amount exceeds the total of any undistributed net income for all earlier preceding taxable years. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed net income for such preceding taxable year. * * *

27 We need not here decide what the result would have been had petitioner received the accumulation distribution after her expatriation.

28 It is well settled that a cash method taxpayer is in receipt of income as of the date a check is received whether or not such check is presented to a bank for payment. Kahler v. Commissioner, 18 T.C. 31, 34-35 (1952). Thus, had petitioner or her agent received the distribution check on December 22, 1975, the distribution would have been taxable at the graduated rates. The evidence, however, does not prove when petitioner or her agent actually received the check.

29 The Trust No. 1 instrument was executed on Dec. 28, 1934. The application to it of subsequent changes in the tax laws raises difficult potential issues. From the outset, the parties have limited their arguments with respect to this issue to whether or not the 1975 distribution was constructively received by petitioner prior to her expatriation. We do not know what evidence or arguments would have been presented had respondent taken a broader position. Accordingly, we decide only the issue presented by the parties.

30 Davis v. Commissioner, T.C. Memo. 1978-12.

31 See Rev. Rul. 60-31, 1960-1 C.B. 174, 178, which states among other things, that 'the statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment.'

End of Document

T.C. Memo. 1980-249
United States Tax Court

ROBERT JAMES CARTER, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 12404—78.
|
Filed July 15, 1980.

Attorneys and Law Firms

Robert James Carter, pro se.

Nancy J. Bateman, for the respondent.

MEMORANDUM OPINION

WILBUR, Judge:

Respondent determined a deficiency in petitioner's Federal income tax for the year 1975 in the amount of $195. The only issue for decision is whether $1,073.01 in wages for services rendered during November and December 1974 but not received by petitioner until 1975, were constructively received by petitioner in 1974 within the meaning of section 451. [1]

All of the facts have been stipulated and are found accordingly. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

At the time of the filing of the petition in this case, petitioner Robert J. Carter resided in New York City. He reported his income for 1975 as a cash basis taxpayer. Mr. Carter was unemployed from January through September 1974. He began working for the city of New York as a laboratory technician in the Office of the Chief Medical Examiner in October 1974. Several weeks later, he transferred to the City Health Department. Petitioner worked as a laboratory technician at the Health Department also, with the added benefit of a permanent job title. He received continuous service credit for the time he was with the Chief Medical Examiner. Subsequent to Mr. Carter's transfer, there was a delay in processing his payroll checks, arising out of tardiness in forwarding his records from the Chief Medical Examiner and a backlog in payroll processing in the Health Department. Consequently, despite numerous protests and demands for his past due salary, Mr. Carter did not get paid for 6 weeks. He was paid $1,073.01 in gross wages on January 3, 1975. This represented 4 weeks back pay ($715.34) and 2 weeks timely pay ($357.67). From this point, his paycheck was up to date.

Had Mr. Carter received the 4 weeks back wages on time, in 1974, he would have owed no extra taxes. His total income for 1974 would have been $818.30. Petitioner was advised by an Internal Revenue employee who assisted him in preparing his 1975 Federal income tax return to exclude the $1,073.01 from his 1975 wages because it was attributable to 1974. Petitioner did so. Respondent assessed a $195 deficiency in petitioner's 1975 taxes.

Petitioner contends that he constructively received the income in 1974, because the work was performed in 1974. He argues that he had a permanent job title, and the funds necessary to pay him were in the city budget. He argues that this constitutes constructive receipt since all that was necessary was for the city to transfer the funds from its budget to his budget. Respondent's position is that Mr. Carter must be taxed when he actually received the money in 1975. While we sympathize with petitioner's plight, we hold that there was no constructive receipt of income in 1974 and petitioner must be taxed in 1975 when he was finally paid.

Petitioner is a cash basis taxpayer. All items which constitute gross income are to be included for the taxable year in which actually or constructively received. Section 1.446—1(c)(1)(i), Income Tax Regs. Constructive receipt is defined in section 1.451—2(a), Income Tax Regs., as follows:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of

> its receipt is subject to substantial limitations or restrictions. * * *

The petitioner did not have the free and unrestricted control of his wages prior to actual receipt that this Court has required in order to find constructive receipt. Hornung v. Commissioner, 47 T.C. 428 (1967); Cohen v. Commissioner, 39 T.C. 1055 (1963). Indeed, he tried repeatedly to obtain his back wages during the month of December but was unsuccessful. His control over his wages was clearly subject to substantial limitations or restrictions. Their mere presence in the New York City budget is insufficient to find constructive receipt.

Petitioner appears to recognize that this is the rule of law applicable to his case, but urges that we make an exception in his case that the average man would expect in view of the compelling equities involved. However, as we explained to petitioner at trial, the typical taxpayer expects to pay tax when he receives the income, because only then does he have the money in hand to make the payment. This is the essence of the cash system—an item is income when received and a deduction when paid—and it accords with the practical exigencies as well as obviates requiring the average taxpayer to deal with the complex concepts of more sophisticated accounting systems.

Petitioner would have owed no tax on the income had he received it in 1974, rather than in 1975. But under the cash basis of reporting income, it is taxable in the year received and not in the year producing the smallest tax burden. The rules are clear and must be so for the convenience of all citizens subject to the tax.

While it is truly unfortunate that Mr. Carter became a victim of bureaucratic inefficiency, he clearly did not constructively receive the income in 1974, and as a cash basis taxpayer is taxable on the wages when he actually received them in 1975. We sustain respondent's determination.

Decision will be entered for the respondent.

All Citations

T.C. Memo. 1980-249, 1980 WL 4094, 40 T.C.M. (CCH) 654, T.C.M. (P-H) P 80,249, 1980 PH TC Memo 80,249

Footnotes

1 All statutory references herein are to the Internal Revenue Code of 1954 as amended and in effect for the year in issue.

End of Document

T.C. Memo. 1978-12
United States Tax Court

BEATRICE DAVIS, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 10525—76.

Filed January 12, 1978.

Attorneys and Law Firms

Beatrice Davis, pro se.

R. Dale Eggleston, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DAWSON, Judge:

Respondent determined a deficiency of $4,805.25 in petitioner's Federal income tax for the year 1974. Concessions were made by the respondent. The issues remaining for our decision are:
(1) Whether severance pay sent to petitioner in 1974 by certified mail, return receipt requested was constructively received by her in that year.

(2) Whether petitioner's disbursements for the purchase and installation of a furnace boiler and a water heater for rental property may be expensed and, if not, what are the useful lives of the boiler and heater.

FINDINGS OF FACT

Many of the facts have been stipulated and are found accordingly. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Beatrice Davis (petitioner) resided in Baltimore, Maryland, at the time the petition was filed in this case. Petitioner filed her Federal income tax return for the calendar year 1974 on the cash receipts and disbursements method of accounting.

Petitioner began working for The Chesapeake and Ohio Railway Co. (hereinafter referred to as the Railway) on July 14, 1965. On November 22, 1974, the Railway merged two offices and petitioner's employment was adversely affected. Rather than accepting another position with the Railway, petitioner elected to take severance pay[1] of $17,006.48.

Petitioner was told by the Railway that two months were necessary to process the severance pay and that she would not receive it before 1975. In late December,[2] however, the Railway in accordance with its standard procedure mailed to petitioner her severance pay via certified mail, return receipt requested. A postal employee attempted to deliver the certified letter on December 31, 1974. Since petitioner was not at home, the postal employee left a notice which stated that the letter could be picked up at the Gwynn Oak Post Office Branch after three o'clock p.m. that day.

Petitioner returned home after five o'clock p.m., at which time the branch post office was closed. She did not pick up the certified mail until January 2, 1975, when the branch post office reopened. Although she expected the letter to be a notification of an increase in her rent, she discovered it to be her severance pay. Included in the envelope was a covering letter and vouchers for a net amount of $12,650.31. The Railway included the severance pay in petitioner's 1974 Form W—2, but petitioner excluded the gross amount of $17,006.48 from her 1974 return and attached an explanatory note.[3]

Petitioner owns investment rental properties in Baltimore which are located at 4005 Norfolk Avenue and 3517 Lucille Avenue. On December 4, 1974, petitioner replaced a defective boiler, which is a part in the furnace in her Norfolk Avenue property. The price of the boiler was $682.60; tax was $27.40; installation and labor charge was $325. The petitioner was allowed a credit of $69.37 against the price of the boiler under the terms of a 20 year guarantee on the old boiler which petitioner had purchased in 1961. The aggregate cost exclusive of tax was $938.23. The new boiler was guaranteed for a period of one year against defects in material or workmanship. In February 1975, the new boiler required numerous repairs and then stopped working altogether. On March 4, 1975, the new boiler was replaced free of charge under the terms of the guarantee. Although the final replacement boiler required several service calls, it was still in service at the time of the trial of this case in October 1977.

On July 26, 1974, petitioner replaced a seven year old gas not water heater in her Lucille Avenue property. The cost of the new hot water heater was $59.88; the valves were $10.77; labor and plumbing charge was $50; and miscellaneous handling was $2.83, for a total of $123.48. The hot water heater was guaranteed against leakage for a period of five years. The valves were guaranteed for one year. The new hot water heater was still in operation at the time of the trial in this case in October 1977.

On her 1974 return petitioner deducted the entire cost of replacing the furnace boiler and the water heater. In the notice of deficiency respondent disallowed the expense deductions. In recomputing petitioner's taxable income, respondent determined that a deduction for water heater depreciation based on a five year useful life was allowable, but allowed no depreciation deduction for the furnace boiler.

ULTIMATE FINDINGS OF FACT

1. The severance pay was not actually or constructively received by petitioner in 1974.

2. The expected useful life of the furnace boiler purchased by petitioner for her Norfolk Avenue property is twelve years

3. The expected useful life of the hot water heater purchased by petitioner for her Lucille Avenue property is five years.

OPINION

The first issue for decision is whether petitioner constructively received her severance pay in 1974. The evidentiary facts related to this issue are not disputed. Although petitioner did not expect to receive the severance pay until 1975, the Railway mailed it to her in late December via certified mail, return receipt requested. A postal employee attempted delivery on December 31, 1974, but petitioner was not at home. Petitioner arrived home after the post office had closed and she saw the notice of attempted delivery of certified mail which she expected to be a notice of increase in her rent. Petitioner picked up the letter when the post office reopened on January 2, 1975, and discovered the certified mail to be her severence pay.

Respondent contends that petitioner constructively received the pay in 1974 since the severance payment was unqualifiedly committed to petitioner on December 31, 1974, and the checks were made available to petitioner at the post office after three o'clock p.m. on the same date. Petitioner argues, on the other hand, that there was no constructive receipt since the check was mailed in the ordinary course of business, was not actually received until 1975, and was not intentionally delayed in transit by petitioner. We agree with petitioner. [4]

The Federal income tax is based on a computation period which is the taxable year. Section 451(a) [5] provides the general rule that 'any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.' Since petitioner is on the cash receipts and disbursements method based on a calendar taxable year of accounting, income is taxable to her in the year the item is actually or constructively received. Sections 1.446—1(c)(1)(i), and 1.451—1(a), Income Tax Regs. Petitioner did not actually receive the severance pay in 1974, so the issue is whether she constructively received it in that year.

The doctrine of constructive receipt is based on the principle that income is received or realized by cash method taxpayers 'when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession.' Loose v. United States, 74 F.2d 147, 150 (8th Cir. 1934), affg. 4 F.Supp. 375 (W.D. Mo. 1933). The regulations provide that:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of

its receipt is subject to substantial limitations or restrictions. (Section 1.451—2(a), Income Tax Regs.)

Although these general principles are well-settled and easily stated, each case necessarily turns on its facts and the doctrine of constructive receipt should be applied sparingly. Thomas v. Commissioner, 44 B.T.A. 735, 738 (1941); Gollett v. Commissioner, 31 B.T.A. 1067, 1069 (1935); Adams v. Commissioner, 20 B.T.A. 243, 245—46 (1930), affd. 54 F.2d 228 (1st Cir. 1931). 'It is only in unique circumstances and a clear case that the invoking of this doctrine will be approved.' Roach v. Commissioner, 20 B.T.A. 919, 925 (1930). The facts of petitioner's situation here do not present such a case.

Respondent is correct in his contention that the Railway had unqualifiedly committed the funds to petitioner by December 31, 1974, but such a commitment is not sufficient in itself to cause constructive receipt. The funds must be made available to the taxpayer without substantial limitations, Section 1.451—2(a), Income Tax Regs. Implicit in availability is notice to the taxpayer that the funds are subject to his will and control. Such notice is lacking here.

Petitioner had no expectation that she would receive the payment in 1974. The Railway had told her it would take months to process her severance pay and that she would not receive the checks until 1975. We see no reason to charge her with constructive receipt simply because she received a notice of attempted delivery of certified mail on December 31, 1974. Petitioner had no inkling that the certified mail was her severance pay; she thought it was a notice of rent increase. Receipt for tax purposes did not effectively occur until January 2, 1975, at which time petitioner actually received the letter and discovered it to be her pay.

Respondent argues that petitioner should be charged with constructive receipt since she would have actually received the payment in 1974 but for the fact that she chose not to be at home on December 31, 1974. We find this argument unpersuasive. It is true that case law has consistently held that any delay in receipt, any substantial limitation or any restriction cannot be of the taxpayer's unilateral making. See, e.g., Romine v. Commissioner, 25 T.C. 859, 873—75 (1956); Frank v. Commissioner, 22 T.C. 945, 952—53 (1954), affd. 226 F.2d 600 (6th Cir. 1955); Kunze v. Commissioner, 19 T.C. 29, 31—32 (1952), affd. 203 F.2d 957 (2d Cir. 1953). Those cases, however, dealt with situations where the taxpayer knew he could have receipt in the earlier year and took steps specifically designed to prevent actual receipt. The error in respondent's logic lies in equating petitioner's choice to be absent from home with a conscious choice not to receive the severance pay until the following year. In fact, petitioner's absence here was not procured to prevent actual receipt. Under these circumstances [6] application of the doctrine of constructive receipt is inappropriate. '(I)n general, income should not be construed to have been received prior to the date of actual receipt except where a taxpayer turns his back upon income or does not choose to receive income which he could have if he chose.' Adams v. Commissioner, supra at 246.

Respondent's reliance on McEuen v. Commissioner, 196 F.2d 127 (5th Cir. 1952), revg. a Memorandum Opinion of this Court; Loose v. United States, supra; and Kahler v. Commissioner, 18 T.C. 31 (1952), is misplaced. In the McEuen case the Fifth Circuit concluded that, although not actually received until 1944, a check mailed to the taxpayer at his request in 1943 was constructively received in the year of request. The holding turned on the fact that the payment was at the direction of the taxpayer and the taxpayer could have picked up the check personally but for the geographical distance separating him from the payor. In the instant case the payment time was not subject to petitioner's direction. Furthermore, there is no indication that petitioner could have picked up the check in person; the normal procedure for the Railway was to mail the severance pay after processing the claim.

In Loose v. United States, supra, constructive receipt was found despite the fact that the taxpayer had suffered a stroke which rendered him unable to personally avail himself of actual receipt. Loose is distinguishable from the instant case, however, since there the taxpayer had actual notice of the availability of the income via the cashing of interest coupons which already were in the taxpayer's possession. Moreover, his wife had a power of attorney for access to the coupons and apparently could have cashed them except for her desire to stay with her ill husband. Here petitioner had no actual knowledge or expectation that the income would be available to her in 1974.

Respondent cites Kahler, supra, for the proposition that constructive receipt may be found despite no expectation of income in the earlier year. In Kahler, however, although the taxpayer did not expect to receive the check, he actually received it sometime after five p.m. on December 31 of the earlier year. Petitioner here had no actual receipt until 1975. Kahler is therefore inapposite.

In our judgment the facts in the instant case are inappropriate for the application of the doctrine of constructive receipt. Accordingly, we hold that the severance pay is not taxable to petitioner in the calendar year 1974.

The second issue for our decision concerns petitioner's disbursements for the purchase and installation of a furnace boiler and a water heater. Respondent argues [7] that these disbursements were capital in nature since the boiler and water heater had useful lives of twelve and five years respectively. Petitioner argues that the proper treatment for these disbursements is full deduction as current expenses. We agree with respondent.

An item is a capital expenditure which may not be deducted in full currently if it has a useful life of more than one year. Sections 1.263(a)—1, and 1.263(a)—2, Income Tax Regs. The burden of proof is on petitioner to overcome respondent's determination that the purchase and installation of the furnace and water heater were capital expenditures. Challenge Manufacturing Co. v. Commissioner, 37 T.C. 650, 662 (1962); Rule 142(a), Tax Court Rules of Practice and Procedure. Petitioner failed to meet this burden.

The useful life of an asset 'is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income.' Section 1.167(a)—1(b), Income Tax Regs. The evidence in this record is insufficient to conclude that respondent erred in his determination of the useful lives of the furnace boiler and the water heater. [8] Petitioner's history with previous appliances included useful lives of eleven years for the old boiler and of seven years for the old water heater. These figures are comparable to respondent's determinations. Petitioner has offered no proof that industry averages are less than the figures for useful lives determined by respondent here. Instead, petitioner relies on the much shorter (one year) warranty for the new appliances as an indication of useful life. The length of a warranty, however, has little or no bearing on the useful life of an asset. Furthermore, although the furnace boiler malfunctioned in the first year it was replaced free of charge under the terms of the warranty. Under these circumstances we are not prepared to say respondent erred in his determination.

We also disagree with petitioner's contention that the installation charges should be expensed. Disbursements for installing a capital item are themselves capital in nature and must be depreciated over the life of the asset. See Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850, 855—57 (1964), affd. 349 F.2d 515 (1st Cir. 1965); Rankin v. Commissioner, 17 B.T.A. 1301, 1308 (1929), affd. in part and revd. in part 60 F.2d 76 (6th Cir. 1932),

Accordingly, we hold that the disbursements for the purchase and installation of the furnace boiler and water heater were capital expenditures for assets with useful lives of twelve and five years respectively.

To reflect the concessions made by the respondent and our conclusions on the disputed issues,

Decision will be entered under Rule 155.

All Citations

T.C. Memo. 1978-12, 1978 WL 2722, 37 T.C.M. (CCH) 42, T.C.M. (P-H) P 78,012, 1978 PH TC Memo 78,012

Footnotes

1 Under the union agreement petitioner was entitled to her daily rate of pay of $45.23 for 376 days, which included 16 vacation days.

2 The envelope containing the severance pay was post-marked December 30, 1974.

3 On January 6, 1975, petitioner applied for a ruling on this issue from the Internal Revenue Service but did not receive respondent's adverse written ruling until after she had filed her 1974 return. Apparently petitioner's circumstances became the subject of Revenue Ruling 76—3, 1976—1 C.B. 114.

4 Petitioner raises an alternative argument with which we disagree. Petitioner argues that inclusion of the severance pay in 1974 would materially distort her income for that year since the pay represents one year of pay, computed from her date of separation on November 22, 1974. We reject this argument. A taxpayer on the cash receipts and disbursements method must include compensation in the year actually or constructively received, regardless of the period in which the

services were actually rendered. Lavery v. Commissioner, 5 T.C. 1283, 1288—89 (1945), affd. 158 F.2d 859 (7th Cir. 1946). This rule applies by analogy to petitioner's case.

The concept of clear reflection of income has its origin in a specific statutory grant of power to the Commissioner of Internal Revenue to change a taxpayer's method of accounting if necessary to clearly reflect income. Sec. 446(b), I.R.C. 1954. Although a taxpayer may resist a change sought by the Commissioner by arguing that under the taxpayer's method there is clear reflection of income, see, e.g., Auburn Packing Co. v. Commissioner, 60 T.C. 794 (1973); Fort Howard Paper Co. v. Commissioner, 49 T.C. 275 (1967), a taxpayer may not affirmatively assert the doctrine, if the Commissioner is merely seeking inclusion under the method previously adopted by the taxpayer. Since petitioner uses the cash receipts and disbursements method, the issue for our decision is only whether under that method the pay was constructively received in 1974.

5 Unless specified otherwise, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

6 Much of respondent's argument is devoted to hypotheticals with extreme variations of the facts in the instant case. Although such hypotheticals sometimes help to place things in perspective, we find them to be little aid in our determination here. In any event, our holding is limited to the facts of petitioner's case and we will refrain from exploring the factual variations posed by respondent until such time as they are embodied in an actual case before this Court.

7 On brief, respondent concedes that he erred in his determination of no allowable deduction in 1974 for depreciation for the boiler under section 167 and for sales tax of $27.40 for the boiler under section 164.

8 Although we found petitioner to be a credible witness, her testimony indicates that she was not particularly knowledgeable as to the mechanics or construction of the furnace boiler. For this reason we discount her testimony that, unlike the original boiler, the components of the replacement boiler could not be replaced and it therefore has a shorter useful life. The other evidence of record provides insufficient information for us to conclude that the new boiler necessarily would have a useful life shorter than the twelve year life determined by respondent, which figure is close to the actual eleven year life of the initial boiler.

Notice 2014-21

SECTION 1. PURPOSE

This notice describes how existing general tax principles apply to transactions using virtual currency. The notice provides this guidance in the form of answers to frequently asked questions.

SECTION 2. BACKGROUND

The Internal Revenue Service (IRS) is aware that "virtual currency" may be used to pay for goods or services, or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance – but it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. For a more comprehensive description of convertible virtual currencies to date, see Financial Crimes Enforcement Network (FinCEN) *Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (FIN-2013-G001, March 18, 2013).

SECTION 3. SCOPE

In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. This notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term "virtual currency" as used in Section 4 refers only to convertible virtual currency. No inference should be drawn with respect to virtual currencies not described in this notice.

The Treasury Department and the IRS recognize that there may be other questions regarding the tax consequences of virtual currency not addressed in this notice that warrant consideration. Therefore, the Treasury Department and the IRS request comments from the public regarding other types or aspects of virtual currency transactions that should be addressed in future guidance.

Comments should be addressed to:

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2014-21)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered Monday through Friday between the hours of 8 A.M. and 4 P.M. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2014-21)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, taxpayers may submit comments electronically via e-mail to the following address: Notice.Comments@irscounsel.treas.gov. Taxpayers should include "Notice 2014-21" in the subject line. All comments submitted by the public will be available for public inspection and copying in their entirety.

For purposes of the FAQs in this notice, the taxpayer's functional currency is assumed to be the U.S. dollar, the taxpayer is assumed to use the cash receipts and disbursements method of accounting and the taxpayer is assumed not to be under common control with any other party to a transaction.

SECTION 4. FREQUENTLY ASKED QUESTIONS

Q-1: How is virtual currency treated for federal tax purposes?

A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?

A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.

Q-3: Must a taxpayer who receives virtual currency as payment for goods or services include in computing gross income the fair market value of the virtual currency?

A-3: Yes. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency,

measured in U.S. dollars, as of the date that the virtual currency was received. See Publication 525, *Taxable and Nontaxable Income*, for more information on miscellaneous income from exchanges involving property or services.

Q-4: What is the basis of virtual currency received as payment for goods or services in Q&A-3?

A-4: The basis of virtual currency that a taxpayer receives as payment for goods or services in Q&A-3 is the fair market value of the virtual currency in U.S. dollars as of the date of receipt. See Publication 551, *Basis of Assets*, for more information on the computation of basis when property is received for goods or services.

Q-5: How is the fair market value of virtual currency determined?

A-5: For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.

Q-6: Does a taxpayer have gain or loss upon an exchange of virtual currency for other property?

A-6: Yes. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. See Publication 544, *Sales and Other Dispositions of Assets*, for information about the tax treatment of sales and exchanges, such as whether a loss is deductible.

Q-7: What type of gain or loss does a taxpayer realize on the sale or exchange of virtual currency?

A-7: The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or

business are examples of property that is not a capital asset. See Publication 544 for more information about capital assets and the character of gain or loss.

Q-8: Does a taxpayer who "mines" virtual currency (for example, uses computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger) realize gross income upon receipt of the virtual currency resulting from those activities?

A-8: Yes, when a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. See Publication 525, *Taxable and Nontaxable Income*, for more information on taxable income.

Q-9: Is an individual who "mines" virtual currency as a trade or business subject to self-employment tax on the income derived from those activities?

A-9: If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax. 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 on to make a profit.

Q-10: Does virtual currency received by an independent contractor for performing services constitute self-employment income?

A-10: Yes. Generally, self-employment income includes all gross income derived by an individual from any trade or business carried on by the individual as other than an employee. Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax. See FS-2007-18, April 2007, *Business or Hobby? Answer Has Implications for Deductions*, for information on determining whether an activity is a business or a hobby.

Q-11: Does virtual currency paid by an employer as remuneration for services constitute wages for employment tax purposes?

A-11: Yes. Generally, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions

Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, *Wage and Tax Statement*. See Publication 15 (Circular E), *Employer's Tax Guide*, for information on the withholding, depositing, reporting, and paying of employment taxes.

Q-12: Is a payment made using virtual currency subject to information reporting?

A-12: A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities, and compensation.

Q-13: Is a person who in the course of a trade or business makes a payment using virtual currency worth $600 or more to an independent contractor for performing services required to file an information return with the IRS?

A-13: Generally, a person who in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, *Miscellaneous Income*. Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in U.S. dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC. See the Instructions to Form 1099-MISC and the General Instructions for Certain Information Returns for more information. For payments to non-U.S. persons, see Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

Q-14: Are payments made using virtual currency subject to backup withholding?

A-14: Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payor must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required. See Publication 1281, *Backup Withholding for Missing and Incorrect Name/TINs*, for more information.

Q-15: Are there IRS information reporting requirements for a person who settles payments made in virtual currency on behalf of merchants that accept virtual currency from their customers?

A-15: Yes, if certain requirements are met. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, *Payment Card and Third Party Network Transactions*, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds $20,000. When completing Boxes 1, 3, and 5a-1 on the Form 1099-K, transactions where the TPSO settles payments made with virtual currency are aggregated with transactions where the TPSO settles payments made with real currency to determine the total amounts to be reported in those boxes. When determining whether the transactions are reportable, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.

See The Third Party Information Reporting Center, http://www.irs.gov/Tax-Professionals/Third-Party-Reporting-Information-Center, for more information on reporting transactions on Form 1099-K.

Q-16: Will taxpayers be subject to penalties for having treated a virtual currency transaction in a manner that is inconsistent with this notice prior to March 25, 2014?

A-16: Taxpayers may be subject to penalties for failure to comply with tax laws. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under section 6721 and 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Keith A. Aqui of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information about income tax issues addressed in this notice, please contact Mr. Aqui at (202) 317-4718; for further information about employment tax issues addressed in this notice, please contact Mr. Neil D. Shepherd at (202) 317- 4774; for further information about information reporting issues addressed in this notice, please contact Ms. Adrienne E. Griffin at (202) 317-6845; and for further information regarding foreign currency issues addressed in this notice, please contact Mr. Raymond J. Stahl at (202) 317- 6938. These are not toll-free calls.

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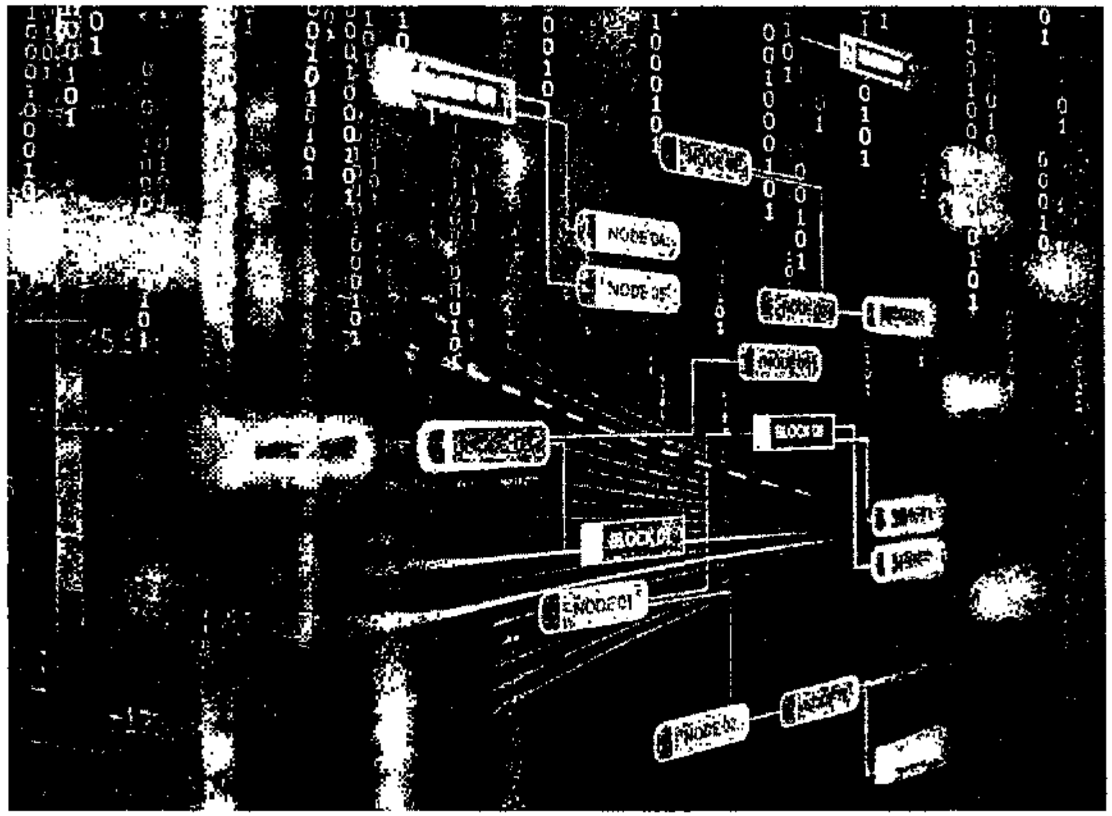

Crypto Assets: Understanding Current Guidance and Why It Need Not Be So Cryptic

January 13, 2020

Speakers

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Michael Meisler
Ernst & Young LLP
Partner

Lisa Zarlenga
Steptoe & Johnson, LLP
Partner

Nicholas Mowbray
BakerHostetler
Associate

Pamela Lew
IRS Office of Chief Counsel

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Polling Question #1

Based on your knowledge, do you believe the regulation of crypto assets is consistent across regulators?

1. Yes
2. No
3. I have no idea

Objectives

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- Understand the technology behind crypto assets
- Provide an overview of the relevant U.S. federal income tax authorities that govern the taxation of cryptocurrency
- Understand U.S. federal tax issues that holders of cryptocurrencies face
- Understand U.S. federal tax issues that issuers of cryptocurrencies face
- Provide an overview of current IRS enforcement activities
- Provide an overview of what areas may be addressed by future guidance

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Agenda

- Overview of Terminology – Crypto Assets
- Tax Considerations for Holders and Purchasers of Cryptocurrencies
  - Capital asset vs. ordinary asset
  - Exchange considerations and IRC Sec. 1256
  - IRC Sec. 864(b) and trading safe harbor
  - Wash sale rules
  - Straddle rules
  - Crypto lending (monetizing without selling)
  - Forks and airdrops
  - Computing amounts realized
  - Determination of basis

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Agenda (continued)

- Tax Considerations for Issuers of Crypto Assets
  - Initial Coin Offerings (ICOs)
  - Security Token Offerings (STOs)
  - Simple Agreement for Future Tokens (SAFTs)
  - Simple Agreement for Future Equity or Tokens (SAFE-Ts)
- State and local tax considerations
- Reporting and enforcement considerations
- Future Guidance on Crypto Assets

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Overview – Crypto Assets

What are tokens?

- Transferable units generated within a distributed network that tracks ownership of the units through the application of blockchain technology
- What are virtual currencies/payment tokens?
- What are security tokens?
- What are utility tokens?

What is a distributed ledger?

- Database that is shared and administered in a decentralized form across a network with the ledger built on a data structure known as "blocks" that combine to make a "chain"
  - Network of computers or users (referred to as "nodes") broadcast transactions to the network and a consensus mechanism validates the transactions and adds them to the ledger
  - Most common consensus mechanisms are "mining" and "staking"

What is blockchain?

- One type of distributed ledger
- Secure environment that encrypts transactions
- Blocks store data and through the blockchain, new blocks are cryptographically validated through nodes and added to the end of the chain

What is a digital wallet?

- Stores private and public keys that are needed to access a blockchain
- Hot vs. cold wallets

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Tax Considerations for Holders and Purchasers of Cryptocurrencies

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For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

IRS Notice 2014-21

25 March 2014

Additional guidance (Since Notice 2014-21)

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- Rev. Rul. 2019-24 (Issued 9 October 2019)
  - Addresses issues related to tax treatment of taxpayers following a hard fork of a blockchain
  - More on forks later!
- Frequently Asked Questions (Issued 9 October 2019 and updated 31 December 2019)
  - Provides additional guidance regarding transactions involving cryptocurrency in accord with the issues addressed in Notice 2014-21

Tax considerations for holders and purchasers of cryptocurrencies

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- Capital vs. ordinary
  - Notice 2014-21 and FAQs provide that cryptocurrencies are property
    - Mining – Notice provides that mined tokens give rise to ordinary income upon award, which may be subject to self-employment taxes
    - No discussion of how to treat tokens received for "proof of stake"
    - Rev. Rul. 2019-24 provides that tokens received following a hard fork give rise to ordinary income on "receipt"
- Exchange considerations and IRC Sec. 1256
  - Possibility of 60/40 treatment (long-term vs. short-term capital gain/loss)
    - Mark-to-market treatment for timing
  - Applicability to Bitcoin futures
    - Trade on a Qualified Board or Exchange (i.e., CME)
  - What about other futures contracts?
  - Mixed straddle elections?
- IRC Sec. 864(b) and trading safe harbors
- Wash sale rules
- Straddle rules

Cryptocurrency lending

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- Given the lack of authoritative tax guidance, does cryptocurrency lending in exchange for cash (or other) collateral constitute a sale or exchange subject to tax?
- Is this lending arrangement more akin to a car rental or securities lending?
- Terms of the loan agreement may determine who is the actual economic owner of the asset during the lending term (i.e., beneficiary of hard forks)
- Should we treat "interest" paid on cryptocurrency lending as interest, rent, or something else?
- Information reporting and withholding considerations for cryptocurrency payments

Forks and airdrops

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- What are they?
- Forks – after years of uncertainty – Rev. Rul. 2019-24
  - New tokens received following a hard fork of a blockchain give rise to ordinary income based on the FMV of the token on the date received.
    - Seen as an accession to wealth under general tax principles.
  - Ruling raises some additional questions, but generally dismisses a number of tax-free alternatives that practitioners and taxpayers had considered previously.
    - For example, forks should not be treated as akin to a stock dividend.
    - Also, dismisses the "cow giving birth to a calf" theory.
- Timing – when the taxpayer exercises dominion and control
  - Taxable income recognized at the time the fork is written to the distributed ledger.
  - Taxable income recognized when amounts are credited to taxpayers' accounts where taxpayers hold in a wallet with an exchange.
- Additional information regarding FMV provided in the Frequently Asked Questions released on the same day.
- While ruling deals with a hard fork followed by an airdrop, it's not clear that this guidance applies to all airdrops.
  - Could be a reasonable conclusion based on the application of general principles.

Computing amounts realized

- Tokens received on a cryptocurrency exchange – use amount recorded by the cryptocurrency exchange, net of fees – FAQ, Q&A 25
- If transaction is not recorded or is an "off-chain" transaction, use value that would have been recorded in an on-chain transaction – FAQ, Q&A 25
- Peer-to-peer transactions – use value as determined by a cryptocurrency or blockchain explorer that analyzes worldwide indices of cryptocurrencies and calculates values at an exact date and time – FAQ, Q&A 26
  - Appears to mean a global pricing index rather than an "explorer"
  - If the taxpayer does not use a value determined by a global pricing index, the taxpayer must establish that the value used is an accurate representation of FMV – FAQ, Q&A 26
- When transaction involves an exchange of cryptocurrency for other property or services and there is no FMV available for the cryptocurrency, use the FMV of the property received – FAQ, Q&A 27
- Compare Notice 2014-21, Q&A 5

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Determination of basis

- Generally, cost basis, including fees, commissions and other acquisition costs, expressed in US dollars – FAQ, Q&A 7
- For assets received in exchange for goods or services, FMV of cryptocurrency when it is received – FAQ, Q&A 12 and 20
- Basis of property received in exchange for cryptocurrency equals the FMV of the property when received – FAQ, Q&A 17
- Lot identification considerations
  - Specific identification permitted – FAQ, Q&A 38
    - Document the specific unit's unique identifier such as a private key, public key, and address or
    - By records showing the transaction information for all units of a specific virtual currency held in a single account, wallet, or address – FAQ Q&A 39
  - If specific identification isn't used, FIFO accounting should be used – FAQ, Q&A 40
- What should taxpayers do if they have used another method of accounting to date?
  - What if a taxpayer has been using weighted average cost?

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Polling Question #2

For hard forks and airdrops, what is your view on when such asset acquisition is taxable to the recipient:

1. At the moment of the fork/airdrop
2. Upon universal acceptance by the community
3. When the recipient actually receives the asset in their possession
4. When the recipient spends or otherwise uses the asset
5. It depends on the facts and circumstances behind the actual event

Tax Considerations for Issuers of Crypto Assets

Initial Coin Offerings (ICOs)

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- Fundraising mechanism by which projects are funded through the issuance of tokens
- Token issuers generally receive either other cryptocurrencies or fiat currencies in exchange for tokens
  - Taxpayers may have claimed like-kind exchange treatment for pre-TCJA exchanges of tokens
- Tax considerations: security token vs. utility token
  - Debt? Equity? Sale or exchange of goods or services?
  - ICOs, based on their specific facts, may be considered security offerings and subject to the Securities and Exchange Commission's (SEC) oversight
  - Token issuers have generally asserted that tokens are either utility tokens or tokens providing right to exchange token for goods or services and not securities for regulatory purposes
- Acquirer vs. issuer considerations
- After a spike in ICOs through the start of 2018, there has been a significant downturn in these offerings into 2019

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Security Token Offerings (STOs)

- Issuer concedes that tokens are securities for regulatory purposes
- Generally, backed by assets
  - Real estate
  - Currencies
  - Rights to intangible property of the company
  - Equity rights related to company's business
    - Profits/right to dividends
    - Voting rights
    - Liquidation rights
- STOs can grant rights to goods or services (just like ICOs)
  - Similar analysis could be involved to determine appropriate tax treatment
- Potentially, stronger arguments for either debt or equity treatment
  - Potential difference in strength of argument for partnerships vs. corporations?
- Again, no guidance at the moment

Simple Agreement for Future Tokens (SAFTs)

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- SAFTs are investment contracts offered by token developers to interested investors or participants in a project
- SAFTs are intended to be treated as forward contracts for federal income tax purposes
  - Intent to avoid immediate taxation
- IRS has provided no guidance indicating whether it agrees or disagrees with this treatment
- IRC Sec 451(c) considerations following the TCJA
  - Consider how proceeds are treated for GAAP purposes

Simple Agreement for Future Equity or Tokens (SAFE-Ts)

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- SAFE-Ts are investment contracts offered by cryptocurrency developers offering investors equity and/or tokens
  - Agreements generally contain elements of both SAFTs and SAFEs
    - Contingent stock right?
    - SAFT with an equity kicker?
    - Investment unit consisting of both equity and a SAFT?
- While intending forward contract treatment, issuers of SAFE-Ts may have additional arguments supporting at least partial equity issuance treatment

Polling Question #3

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What type of asset class do you feel has the best use case for tokenization:

1. Real estate
2. Stock/securities
3. Commodities
4. Retail/consumer products
5. Authentic collectibles
6. Large assets (such as airplanes)
7. People/pets
8. Other

State and local tax implications

- How are cryptocurrency transactions sourced to different state and local jurisdictions?
- Cryptocurrency is not physical property, which makes physical identification and location difficult
- Many state and local jurisdictions utilize customer-based sourcing
- How should trades through a licensed exchange be sourced if the end customer in the transaction is not identifiable?
- Sales and use tax considerations

Reporting and enforcement considerations – reporting considerations

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- Gains or losses from disposition or spending virtual currency – report on Form 8949, transfer information to Schedule D – FAQ, Q&A 42
- Ordinary income from virtual currency is reported on Form 1040 along with other similar types of income – FAQ, Q&A 43
  - Wages – line 1
    - Wages paid in cryptocurrency are subject to FICA and FUTA taxes
  - Self-employment income – Schedule C
  - Like-kind exchange treatment and the impact of the TCJA on IRC Sec. 1031)
- Form 1040, Schedule 1, Additional Income and Adjustments to Income
  - "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"
  - Includes "Yes" or "No" boxes available to select
  - Similar to Schedule B question regarding offshore bank accounts
    - Potential for similar enforcement activity related to that question

Reporting and enforcement considerations – reporting considerations

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- 2019-2020 Priority Guidance Plan includes virtual currency information reporting project under section 6045.
  - Section 6045 generally provides for information reporting on Form 1099-B for brokers and barter exchanges.
- Reporting of foreign bank and financial accounts (FBAR, FATCA)

Reporting and enforcement considerations – enforcement considerations

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- Recent DOJ/IRS announcement regarding dark web arrests related to payments in Bitcoin
- J5 - Joint international coalition to investigate cryptocurrency related tax crimes and money laundering, including US, UK, Australia, Canada, and the Netherlands
- Coinbase summons
- LB&I compliance campaign
- IRS issues approximately 10,000 letters to taxpayers regarding cryptocurrency transactions
  - Letters ranged from informational to providing calculations of tax due
  - Any calculation of tax due could have been overstated to the extent that the IRS lacked information regarding calculations of adjusted basis
- Potential implications of Form 1040, Schedule 1

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Future Guidance on Crypto Assets

Areas Where Guidance is Needed

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- Chapter 3 withholding and FDAP
- Anti-Deferral Regimes (i.e., PFICs, subpart F, and GILTI)
- UBTI considerations
- Reporting
  - Section 6045 information reporting
  - Basis reporting
  - FBAR/FATCA account reporting
- Classifications (commodities, securities, other)

Summary/Questions?

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Report No. 1433

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE TAXATION OF CRYPTOCURRENCY

January 26, 2020

TABLE OF CONTENTS

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I. INTRODUCTION

This Report comments on the cryptocurrency guidance published by the Internal Revenue Service (the "Service") on October 9, 2019, including Revenue Ruling 2019-24 (the "Ruling") on the treatment of hard forks and the updated "Frequently Asked Questions" ("FAQs" together with the Ruling, the "Guidance").[1] We commend the Service for providing much needed guidance in this area and understand that the Service and the Department of the Treasury ("Treasury") are planning to issue further guidance on cryptocurrency. This Report highlights certain technical aspects of cryptocurrency network structures and market operations covered under the Ruling and the related FAQs and requests that the Guidance be clarified in light of the technical operations of these networks.[2] The Report also identifies additional areas of U.S. federal income taxation in which we believe further specific guidance would be beneficial in the near term.

A. Background Regarding Blockchain Technology

1. Bitcoin and Blockchain Technology

As background to our comments on the Guidance and in particular the Ruling, we believe it would be helpful to summarize the operation of blockchain technology and introduce certain concepts we refer to throughout this Report.

The Bitcoin network is the software protocol behind the first cryptocurrency and began operating on January 3, 2009. The Bitcoin network uses a distributed network of computers running the Bitcoin core algorithm. The Bitcoin network's computer code is "open-source," meaning that the creator and copyright holder grants users the rights to study, change and distribute the software to anyone for any purpose. The core code is therefore open for anyone to download, use, review and inspect, providing complete transparency as to its design and evolution. Importantly, this openness also means it can be copied costlessly by any individual or group with the technical ability and desire to try creating a different virtual currency system.

Bitcoin functions as a digital ledger of transactions recording the movement of its native virtual "currency" also called bitcoin (with a lower case "b") through the use of public and private key cryptography. The Bitcoin network is pre-programmed with a limited supply of 21 million bitcoin currency units. The Bitcoin network's supply of bitcoin is released according to a set deflationary schedule as payment to the operators of the computers providing the computational power required to process and verify transactions on the Bitcoin ledger. These computer operators are referred to as "miners." When holders of bitcoin wish to transfer or otherwise transact in

[1] The principal drafter of this Report was Eschi Rahimi-Laridjani with helpful comments from Kim Blanchard, Andy Braiterman, Robert Cassanos, Justin Cohen, Peter Connors, Kianga Daverington, Daniel Dunn, Jason Factor, Michael Farber, Dominique Gallego, Jonathan Gifford, Ed Gonzalez, Benjamin Heller, Andrew Herman, John Lutz, Jeffrey Maddrey, Jim Mastracchio, Michael Meisler, David Miller, John Narducci, Richard Nugent, Deborah Paul, Richard Reinhold, Zuza Savoff, Robert Scarborough, Mike Schler, Michael Shulman, Bryan Skarlatos, Andrew Solomon, Corey Spector, Nathan Tasso and Shun Tosaka. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or House of Delegates of the New York State Bar Association.

[2] The Service also could consider issuing guidance in a form that is not sub-regulatory and elevating the FAQs to a level that provides penalty protection to taxpayers.

bitcoin, transactions are broadcast to the network by users and collected by computers (referred to as "full nodes") run by miners and other participants who choose to download and run the Bitcoin core protocol software connected to the Internet. In this process, computers running the protocol constantly scan the network for transactions waiting to be detected and processed. These computers check that submitted transactions are consistent with prior states of the distributed ledger, and, once a transaction is verified as valid (*i.e.* it is confirmed that the value being transferred is available for transfer), that transaction is posted to the "memory pool" from which miners choose transactions to add to the ledger. Transactions are then grouped together and published in sequential blocks. Grouping is done based on factors that include timing of the transaction and the transaction fees offered to miners by senders. Each "block" is fixed in size, which limits the number of transactions that can be confirmed and published together. Since different transactions contain varying amounts of data, the number of transactions that can fit in a block varies and will contribute to the determination of which transactions are grouped together in the confirmation process. This network structure has given rise to the term "blockchain" and its corresponding method for achieving agreement (or consensus) as to the state of the network (including the validity of transactions) is referred to as a "proof-of-work" system.

More generally, blockchain is a form of distributed ledger technology used to refer to the technology that underlies many cryptocurrencies, including but not limited to bitcoin. With respect to each cryptocurrency with a proof-of-work consensus mechanism, the miners, together with decentralized groups of voluntary developers, users, hobbyists, investors and traders of varying levels of sophistication form a global community of participants whose collective actions and behaviors determine the future development, adoption and success of the relevant network.

Today, www.coinmarketcap.com, a leading website that provides market information about cryptocurrencies lists information for nearly 5,000 different cryptocurrency assets, representing countless groups of developers, users, investors and traders from around the world. What started with Bitcoin a decade ago has led to experimentation and innovation around the world creating potential applications in areas beyond virtual currencies.[3] However, these projects vary widely in terms of legitimacy, adoption, size and viability and the top ten cryptocurrencies account for about 85% of the quoted total market capitalization of approximately US$200 billion as of the end of 2019.[4]

2. *Coins and Tokens*

The cryptocurrency associated with a particular public blockchain or other distributed ledger technology network is often referred to as a coin or token. While frequently used interchangeably, coins generally have been designed as a form of digital money for payments. Tokens, on the other hand, have additional embedded functionality in that they are necessary inputs for the internal operation of their related network, provide holders with access to products or

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[3] Sangeet Paul Choudary, Marshall W. Van Alstyne & Geoffrey G. Parker, *Platforms and Blockchain Will Transform Logistics*, HARVARD BUSINESS REVIEW, (Jun. 19, 2019), https://hbr.org/2019/06/platforms-and-blockchain-will-transform-logistics; Irving Wladawsky-Berger, *Blockchain Marks the Next Step in the Internet's Evolution*, THE WALL STREET JOURNAL, (Aug. 2, 2019), https://blogs.wsj.com/cio/2019/08/02/blockchain-marks-the-next-step-in-the-internets-evolution/.

[4] Cryptolization, https://cryptolization.com/ (last visited Jan. 2, 2020).

services (in addition to storing value and permitting fast, secure and inexpensive transfer of value over the Internet), or may be consumed as a kind of natural resource required for third party programs to operate on that system (*e.g.*, the cryptocurrency ether on the Ethereum blockchain).

3. *Public and Private Keys*

The transfer of bitcoin (and other cryptocurrencies) requires the use of a public and a private key. The public key is associated with a publicly available address location on the network where balances are recorded and is used to receive funds. The private key is used to "sign" and approve the movement of a specified amount of currency associated with a particular public key and address.

What is colloquially referred to as "holding" coins or tokens or "owning" coins or tokens really translates to holding and controlling the use of private keys associated with addresses on the distributed ledger that contain stated amounts of coins or tokens. The coins and tokens themselves are not digitally held or transferred on devices – the coins and tokens stay on the network and move around to different addresses wherever they are sent according to the instructions of the private key holder, or multiple holders where a multi-signature requirement has been implemented.

4. *Wallets and Exchanges*

Use of cryptocurrencies and their networks requires customized software that, depending on the particular network, can be accessed with the assistance of a user interface that is online, downloaded locally onto a user's computer or mobile device, managed with a purpose-built piece of hardware or even via a physical piece of paper, collectively referred to as "wallets." Each of these methods assists the user in the management and use of private keys required to safeguard, send or move cryptocurrency from one address to another. Wallets that are not connected to the Internet are referred to as "cold wallets," while wallets that are connected are referred to as "hot wallets." Hot wallets provide the user interface and connectivity to be able to transact in the cryptocurrencies supported by a particular wallet.

Wallets can be "custodial" or "non-custodial."[5] With custodial wallets, the public and private keys are managed by a third-party service provider and are not directly available to the end user. With a non-custodial wallet, by contrast, the end user has direct access to the public and private keys associated with the wallet, and thus has more direct control over the cryptocurrency associated with that wallet. In the case of non-custodial wallets, the wallet provider is not supposed to have access to a wallet holder's private keys.

Many users hold cryptocurrency balances on centralized platforms offering services for the purchase and exchange of cryptocurrency, commonly referred to as "exchanges." When a user holds an account on an exchange (a type of custodial wallet) that user does not directly have access to the private keys associated with cryptocurrency balances reflected on the public ledger of a particular blockchain. Instead, the user relies on the exchange to manage all private keys, deposits

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[5] Jamie Readman, *The Difference Between Custodial and Noncustodial Services*, BITCOIN, (Nov. 29, 2018), https://news.bitcoin.com/the-difference-between-custodial-and-noncustodial-cryptocurrency-services/; Alvin Hagg, *Custodial and Non-Custodial Wallet Comparison*, FREEWALLET, (May 24, 2019), https://freewallet.org/blog/custodial-vs-non-custodial-wallet.

and withdrawals on behalf of the user. Accordingly, a user's trading activity and account balances are recorded on private ledgers that are internal to the platform with only periodic batches of transactions representing groups of deposits and withdrawals of cryptocurrency being submitted and processed on the actual blockchain, or "on-chain", by the relevant platform. Exchanges may not actually hold coins or tokens matching all coins and tokens credited to their customers' accounts. Given limited regulation of exchanges in many jurisdictions, there is little transparency about how much cryptocurrency an exchange actually owns.

5. *Private Blockchains*

In addition to cryptocurrencies such as bitcoin and similar networks or "projects" that are considered to be "public" and "permissionless," there is a separate world of "private" and "permissioned" blockchains that are created, and access to which is controlled, by private organizations, usually corporations or consortia of companies within an industry, for a specific purpose useful to a limited group of participants.

B. Forks

1. *Soft Forks*

As discussed above, cryptocurrency essentially is a software protocol that runs across a network of computers that create and maintain a shared ledger of transactions. The cryptocurrencies discussed in the Guidance are recorded on a distributed ledger that is open for participation and inspection by anyone with the right software tools or network user interface. Since the software is open source all interested parties with the requisite skills can duplicate and modify it. Modifications of the software that do not break compatibility across the network – allowing transactions to continue to be verified and added to the existing ledger using pre-fork versions of the software (a concept known as "backward compatibility") - are referred to as soft forks.

2. *Hard Forks*

Modifications in the software that go to the core rules on which the entire network must agree can result in a new version of the software that is no longer compatible with the unmodified software.[6] Modifications to the software that break compatibility between the unmodified version of the software and the modified version after the point in time such modifications are introduced give rise to hard forks. Each leg of the fork now applies different rules to reviewing and verifying transactions, so the blockchain splits into an original chain and a new chain.

There are essentially two varieties of hard forks: contentious and non-contentious. A non-contentious hard fork is a form of software update with similar intentions and outcomes as a soft fork, but depending on the nature of the changes it may require that alternative versions of the network protocol be incompatible with the upgrade (*i.e.* that there be no backward compatibility),

[6] Peter Van Valkenburgh, *What Are Cryptocurrency Forks, Airdrops, and What's the Difference?* COIN CENTER, (Oct. 17, 2019), https://coincenter.org/entry/what-are-cryptocurrency-forks-airdrops-and-what-s-the-difference.

thereby essentially requiring the entire community to adopt and use the new version.[7] In cases where a hard fork is contentious, it means there is fundamental disagreement among significant parts of the community of project participants as to the future technical direction of the network such that at the time of the hard fork two incompatible versions of the network survive and continue their development along different road maps. The outcome of a contentious hard fork can lead to debates over which cryptocurrency is entitled to use the original name, logo and trading abbreviation.

In addition to contentious hard forks in which there is a rift in the community of project participants for an existing blockchain network, there are also hard forks created with the intention of establishing an entirely new cryptocurrency.[8] Developers use hard forks as a technical method to jumpstart a new cryptocurrency and leverage name recognition, network effects as well as technical specifications of an existing blockchain for the benefit of a new project. Such "new project" hard forks operate in ways that are very similar to contentious hard forks and are intended to result in two chains going forward, similar to a contentious hard fork in which both the legacy and new chains survive. "New project" hard forks generally are more common than contentious hard forks. The discussion of contentious hard forks in Part II of the Report therefore addresses both contentious hard forks and hard forks intentionally used to create new projects.

Given the open source nature of the software underlying cryptocurrencies, hard forks can arise easily. Anyone with the requisite technical expertise and the desire to create a hard fork (whether as part of a disagreement about the direction of a given blockchain community or to create an entirely new project) can do so and hard forks are quite common. By way of example, based on research by Forkdrop.io there are currently 50 Bitcoin active fork projects and 20 historic fork projects.[9] Many of those fork projects are or were deliberate attempts to create a new cryptocurrency. Contentious hard forks resulting from a rift within a community are relatively rare and those resulting in two independently viable, widely traded and actively developing projects are rarer. We understand that Bitcoin Cash is the only currently operating contentious hard fork of the original Bitcoin chain[10] that meets the foregoing standard and that Ethereum

[7] A non-contentious hard fork of the Ethereum network referred to as "Istanbul" occurred on December 7, 2019. Adrian Zmudzinski, *Ethereum Istanbul Hard Fork Get Support From Major Crypto Exchanges*, COINTELEGRAPH, (Dec. 9, 2019), https://cointelegraph.com/news/ethereum-istanbul-hard-fork-get-support-from-major-crypto-exchanges; Christine Vasileva, *Ethereum Istanbul Hard Fork Completed Successfully*, BITCOINIST, (Dec. 7, 2019), https://bitcoinist.com/less-than-4-hours-ethereum-istanbul-hard-fork/.

[8] Two examples are Bitcoin Gold and Bitcoin Private. *See* Christina Comben, *The Real Story Behind Bitcoin Gold From One of Its Creators*, COIN RIVET, (Nov. 16, 2019), https://coinrivet.com/the-real-story-behind-bitcoin-gold-from-one-of-its-creators/; Nikolai Hushchak, *An Investment in Bitcoin Private. Why Should You?* GOOD AUDIENCE, (Jun. 3, 2018), https://blog.goodaudience.com/an-investment-in-bitcoin-private-why-should-you-c3f571e737d1.

[9] Forkdrop, http://www.forkdrop.io (last visited Jan. 2, 2019).

[10] The Bitcoin Cash network subsequently split into two chains in a further contentious hard fork, Bitcoin ABC (which since has acquired the original name Bitcoin Cash) and Bitcoin SV (Satoshi Vision). While Bitcoin SV still has some support, it may eventually die out since most of the largest exchanges and wallet providers do not support it. *See* Sead Fadilpašić, *Is Bitcoin SV About to Sabotage Itself?* CRYPTO NEWS, (Dec. 18, 2019), https://cryptonews.com/news/is-bitcoin-sv-about-to-sabotage-itself-5340.htm; Christine Masters, *BitGo Wallet to Stop Bitcoin SV (BSC) Support in February*, CRYPTOVEST, (Dec. 18, 2019), https://cryptovest.com/news/bitgo-wallet-to-stop-bitcoin-sv-bsv-support-in-february/.

similarly has only had one surviving contentious hard fork that at this time meets the foregoing standard.

3. *Consequences of a Hard Fork*

When a contentious hard fork (or a new project fork) occurs, a new chain emerges that shares an identical history with the original, or legacy, chain up to the point of the split.[11] The historical record of coins or tokens on the legacy chain is shared by the forked copy creating an identical number of coins or tokens available for use on the new chain. Thus, the mere occurrence of the hard fork results in the creation of coins or tokens on a separate blockchain with new technical specifications that are available in identical quantity to holders of the original coins or tokens.

If the hard fork is implemented among participants in a single cryptocurrency community and the purpose of the hard fork is not contentious, *i.e.* there is universal agreement and adoption of the new version, the hard-forked version should inherit all the defining characteristics, network effects and market infrastructure support enjoyed by that network's coin or token prior to the hard fork. In that case, the legacy chain will be abandoned and cease to exist for all practical purposes. Coins or tokens associated with the legacy technology will cease to have any value or usability as all network infrastructure (miners, exchanges, etc.) will no longer support the legacy version. It will therefore not be possible in practice to transact on the legacy chain unless programmers and market participants take steps in the future to revive the legacy chain and build up a new infrastructure.[12]

Where a hard fork is contentious and two viable currencies survive, typically one of the groups will adopt a new name so that a new community can organize and develop along a different path.

Whether a hard fork within a single blockchain's community is contentious or non-contentious, no coins or tokens are airdropped in connection with the hard fork. Instead, the new coins or tokens come to exist by virtue of the transaction ledger of the legacy network being copied to create a new and separate blockchain. Owners of coins or tokens on the legacy chain cannot access new coins or tokens without technical upgrades to permit access to coins or tokens under the new protocol. The required upgrades may exceed the technical expertise of many owners holding through cold wallets or other wallets that are not supported by third party service providers. If coins or tokens are held through a wallet provider or an exchange, those service providers need to take the necessary steps to make new coins or tokens accessible to their customers. Modifying the software to be able to access new coins and tokens can be costly, in that holders or service

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[11] Peter Van Valkenburgh, *What Are Cryptocurrency Forks, Airdrops, and What's the Difference?*, COIN CENTER, (Oct. 17, 2019), https://coincenter.org/entry/what-are-cryptocurrency-forks-airdrops-and-what-s-the-difference.

[12] An example of this phenomenon is Sia Classic where after a largely non-contentious hard fork some members of the community tried to keep the legacy chain alive. Scott Ellis, *SiaClassic: Declaration of Independence*, MEDIUM, (Oct. 13, 2018), https://medium.com/siaclassic/siaclassic-declaration-of-independence-315284c56147. However, Sia Classic is not listed on Coin Market Cap and does not otherwise have an active support network to date.

providers may need to hire specialized personnel to carry out the necessary upgrade. So access to new coins or tokens resulting from a hard fork is neither automatic nor costless.

4. *When Does a Hard Fork Occur?*

It is not crystal clear that there is a general consensus or standard to apply on when in time a hard fork can be confirmed to have occurred. A hard fork may be announced by the team launching it but not all announcements are followed by actual launches, let alone hard forks with discernable secondary market trading volumes or active development. Technically, when a hard fork occurs, it is measured from a particular "block" or location on the blockchain. At that time, operators of different versions of the protocol can broadcast their participation in a manner that is openly visible for programmers. Steps required by market participants to access new coins or tokens vary depending on the particular technical methods developers adopt to effect the operation of the new blockchain. The variety of feasible approaches raises the question of whether and when the hard fork can be said to occur: (x) at the time a "snapshot" of the old blockchain is taken to record the location on the blockchain from which the fork diverges, (y) at the time the new protocol begins running (without external network support) with a detectable threshold of computing power, which may be visible only to technically expert participants interacting directly with blockchain, or (z) at the later time when the first group of transactions is recorded on the new chain.[13]

C. Airdrops (Giveaways)

Airdrops (or giveaways) are common occurrences but as the terminology has emerged and been used in the industry, they are not connected to hard forks because they do not share a transaction history with another blockchain.[14] Airdrops typically occur for marketing purposes or to promote a new coin or token.[15] Promoters wishing to increase visibility of a new token may scan the Ethereum blockchain and automatically send new tokens to all wallets in relation to the amount of ether in each wallet. Exchange platforms may gift new tokens to account holders -- perhaps in proportion to the amount of that exchange's native token held. Thus, while not technically related to a particular legacy blockchain in the same way as a new coin or token that is obtained via a hard fork, holdings of a particular cryptocurrency may be a necessary qualification for obtaining a giveaway or airdrop.

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[13] An additional twist can be that an exchange working with the fork developers to support the new blockchain may credit persons holding legacy coins and tokens at the time of the snapshot with an instrument tradable on that platform (but which cannot be withdrawn from that platform) as a kind of future in the forked coin or token. We understand that this is a rare occurrence and will require further study. The discussion of token swaps in Part VI.D below is relevant to this analysis.

[14] We note that there have been some instances of a hard fork combined with an airdrop. The first such transaction appears to have been the creation of a new cryptocurrency called Bitcore. However, such combinations remain rare. *See About Bitcore*, COINMARKETCAP, coinmarketcap.com/currencies/bitcore/ (last visited Dec 31, 2019); Jimmy Song, *Bitcoin Diamond / Super Bitcoin / Bitcore: What You Need To Know*, MEDIUM, (Jan. 3, 2018), https://medium.com/@jimmysong/bitcoin-diamond-super-bitcoin-bitcore-what-you-need-to-know-f49c35688a39; *BitCore FAQ*, BITCORE BTX, https://bitcore.cc/faq (last visited Dec. 31, 2019).

[15] Some projects may refer to "giving away" coins or tokens to persons providing services or capital. We do not address these situations when we refer to "giveaways" here.

In many cases, giveaway coins or tokens are created before a functioning blockchain for the underlying project exists and the coins and tokens are given away as a way for projects to raise awareness and money to develop the project through secondary market liquidity if the coins or tokens can be listed on exchanges. The advertised utility usually is not available at the time of the giveaway, in which case the tokens would not be otherwise usable until the promised protocol goes live and the marketing tokens can be "swapped" for new native tokens.

In an airdrop/giveaway, the recipients do not provide consideration for the airdrop and have no control over whether they "receive" airdropped coins or tokens. Often, they may not even be aware of the airdrop/giveaway. If an airdrop/giveaway is received via accounting entries on the books and records of an exchange where the taxpayer has its trading account, the taxpayer may have no way of knowing whether the related blockchain is functioning or whether any transactions have been recorded. Moreover, often promotional airdrops/giveaways into a holder's account on an exchange will not permit immediate withdrawals even if there are live and active order books for purchases and sales of the coins or tokens on that exchange. In some cases, a recipient will have to take actions to obtain the new coins or tokens, for example by signing up on a website or telegram and providing an Ethereum wallet address, or downloading the new product's dedicated wallet and sharing an address unique to the new token. If a recipient does not take these steps it never obtains access to the airdropped coins or tokens.

II. SUMMARY OF RECOMMENDATIONS

1. We recommend that the Service clarify that airdrops as generally understood within the cryptocurrency community do not typically occur in connection with hard forks and that the Service revise the Ruling accordingly.

2. We recommend that the Service distinguish between contentious and non-contentious hard forks and treat a non-contentious hard fork as not resulting in a taxable event.

3. We recommend that the Service clarify how contentious hard forks (including, for this purpose, hard forks that are used to jumpstart new cryptocurrencies) as they actually occur (*i.e.* without an airdrop) should be taxed.

4. We recommend revising the Ruling to focus situation 1 on a non-contentious hard fork and situation 2 on a contentious hard fork (without an airdrop).

5. As discussed in Part III below, based on existing lines of authority, we believe there are four plausible ways of analyzing the consequences of a hard fork: (1) as an accession to wealth, (2) as a non-realization event followed by basis splitting, (3) as a non-realization event giving rise to an asset with a basis of zero and (4) as a taxable sale or exchange.

6. If the third approach listed in recommendation 5 above is chosen, we recommend that the Service provide that, in the case of a sale of the legacy coin or token at a loss, the loss be denied and the amount of the disallowed loss increase the basis of the new coin or token.

7. We recommend that the Service continue to study the taxation of airdrops/giveaways.

8. While we do not recommend a specific approach to the taxation of contentious hard forks and giveaways, we recommend that if Treasury and the Service treat contentious hard forks as giving rise to an "accession to wealth," giveaways be analyzed and treated consistently.

9. As discussed in Part III.B.1.a. below, it is possible that an exchange or wallet provider chooses not to support a new cryptocurrency. We recommend that the Service provide further guidance on how taxpayers will be treated in these circumstances.

10. In light of the challenges in accurately determining fair market value, if Treasury and the Service decide to proceed with an approach to contentious hard forks that requires a determination of the current fair market value of new coins or tokens, we recommend that the Service study how best to develop criteria for identifying reliable pricing sources.

11. We recommend that the Service consider whether to allow reliance on an average price across multiple exchanges or on prevailing market conventions, such as the daily closing price.

12. As discussed in Part III.B.3 below, if the Service pursues the Accession to Wealth or Section 1001 approach to contentious hard forks, we recommend that it study whether a concept of "viability" of a contentious hard fork should be included.

13. In addition or as an alternative to recommendation 12, we recommend that the Service consider a *de minimis* rule establishing that taxpayers do not need to report income where new coins or tokens resulting from a contentious hard fork have a value below a specified threshold. Such a threshold could be based on the average prices on the top exchanges (by volume or liquidity) supporting those coins. We recommend that Treasury and the Service study how best to establish such a threshold.

14. If the Service takes an approach to giveaways that requires current taxation, we recommend a *de minimis* threshold below which no income needs to be reported. We also recommend that at least in situations where coins or tokens are forfeited unless specific actions are taken within the giveaway period, no income be recognized until those actions are taken and, if those actions are never taken within the giveaway period, no income be recognized at all.

15. We recommend that the Service study whether to require at least domestic exchanges and wallet providers to report to the Service the number of coins and tokens (with relevant identifying information) that become available to a taxpayer after a contentious hard fork or in a giveaway in order to facilitate compliant reporting upon receipt or at the time the coins or tokens are subsequently exchanged for cash, other property or services.

16. We recommend that the Service confirm that IRS Form 8300, titled "Report of Cash Payments Over $10,000 Received in a Trade or Business," does not apply to payments received in cryptocurrency.

17. For the reasons discussed in Part V.B below, we recommend that where a taxpayer holds the private keys to cryptocurrency directly the taxpayer's jurisdiction of residence for U.S. federal income tax purposes be treated as the location of the cryptocurrency.

18. As discussed further in Part V.B below, where a taxpayer owns cryptocurrency in a manner in which it does not control the private keys associated with those coins or tokens, such as on an exchange, we recommend that the coins or tokens should be considered located where the service provider controlling the relevant private keys is located.

19. For the reasons discussed in Part V.B.1 below, we recommend that the Service require reporting of cryptocurrency held in accounts on non-U.S. exchanges on IRS Form 8938. We recommend that the Service impose this requirement for future tax years only or, as an alternative, provide a penalty-free extension period for taxpayers to file forms for prior years. We also recommend that the Service study whether cryptocurrency held in other types of custodial wallets supported by non-U.S. service providers be subject to this reporting requirement.

20. For the reasons discussed in Part V.B.2 below, we recommend that if the Service requires reporting on Form 8938, Treasury similarly require FBAR reporting (as defined below).

21. We recommend that Treasury and the Service study how to apply compliance requirements under FATCA (as defined below) to non-U.S. cryptocurrency exchanges.

22. We request that Treasury and the Service issue guidance in the near term with respect to the topics enumerated in Part VI below.

23. For the reasons discussed in Part VI.D below, we recommend that Treasury and the Service issue guidance confirming that token swaps are not taxable and providing that a holder who fails to take steps to exchange the old tokens and thus forfeits its right to receive the new token be entitled to a loss (insofar as the taxpayer had basis in the old token).

24. For the reasons discussed in Part V.G below, we recommend that Treasury and the Service further study "inflation payments" in staking networks.

Our recommendations are provided from the perspective of traditional tax concepts and doctrine.[16] We recognize that the United States government may have a public policy interest in other areas relating to cryptocurrency, such as its environmental impact,[17] its ability to facilitate unlawful transactions[18] and its arguable similarity to gambling. We do not have the expertise to comment on those areas but acknowledge that the government's views in those areas could affect the tax rules it chooses to adopt.

III. CLARIFICATION OF THE TAX TREATMENT OF HARD FORKS

The Ruling describes two situations. In situation 1 an existing cryptocurrency (crypto M) undergoes a hard fork resulting in the creation of a new cryptocurrency (crypto N). A taxpayer owns units of crypto M but is said not to "receive" units of crypto N where no crypto N is "airdropped or otherwise transferred to an account owned or controlled" by the taxpayer. The ruling concludes that under these circumstances the taxpayer does not have gross income. In situation 2 an existing cryptocurrency (crypto R) undergoes a hard fork resulting in the creation of a new cryptocurrency (crypto S). A taxpayer owns 50 units of crypto R. Upon the occurrence of the hard fork, 25 units of crypto S are said to be "airdropped" to the taxpayer's address. As a result of the "airdrop" following the hard fork, the taxpayer is said to have had an accession to wealth and thus to recognize ordinary income. Q&A 23 makes clear that the amount of ordinary income is equal to the fair market value of the new cryptocurrency at the time it is received.

The Ruling concludes with respect to situation 1 that a hard fork that is not followed by an airdrop does not result in the recognition of gross income. As discussed above, hard forks generally are not followed by airdrops. In the paradigmatic case of a contentious hard fork, the split of Bitcoin into Bitcoin and Bitcoin Cash, two new viable blockchains were created, giving rise to separate cryptocurrencies that have become widely held and traded. However, technically, holders of bitcoin did not receive an airdrop of bitcoin cash. Instead, after the hard fork, holders of bitcoin could start transacting in bitcoin cash using the private keys to addresses that held bitcoin at the time of the hard fork to the extent additional technical support or "integration" was made available by third party wallet providers or exchanges which had started supporting bitcoin cash.

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[16] We have started from the premise that cryptocurrency is "property" for U.S. federal income tax purposes, as stated in Notice 2014-21, and have not considered whether there could be other valid tax paradigms, such as viewing cryptocurrency investments as akin to gambling.

[17] *See generally* Christopher Bendiksen and Samuel Gibbons, *The Bitcoin Mining Network: Trends, Average Creation Cost, Electricity Consumption & Sources*, COINSHARES RESEARCH, (May 31, 2019), www.coinshares.co.uk; Alex Hern, *Bitcoin's Energy Usage is Huge – We Can't Afford to Ignore it*, THE GUARDIAN, (Jan. 17, 2018), https://www.theguardian.com/technology/2018/jan/17/bitcoin-electricity-usage-huge-climate-cryptocurrency; Niall McCarthy, *Bitcoin Devours More Electricity Than Switzerland*, FORBES, (July 8, 2019), https://www.forbes.com/sites/niallmccarthy/2019/07/08/bitcoin-devours-more-electricity-than-switzerland-infographic/#680b3c5121c0.

[18] *See generally* Sean Foley, Jonathan R. Karlsen and Talis J. Putnins, *Sex, Drugs, and Bitcoin: How Much Illegal Activity Is Financed Through Cryptocurrencies*, SSRN, (Jan. 17, 2018), https://ssrn.com/abstract=3102645; Rachel Wolfson, *Tracing Illegal Activity Through The Bitcoin Blockchain To Combat Cryptocurrency-Related Crimes*, FORBES, (Nov. 26, 2018), https://www.forbes.com/sites/rachelwolfson/2018/11/26/tracing-illegal-activity-through-the-bitcoin-blockchain-to-combat-cryptocurrency-related-crimes/#1670a20b33a9.

Situation 2 provides that a holder of 50 units of crypto R receives an airdrop of 25 units of crypto S after a hard fork. As discussed above, a typical hard fork results in the creation of an identical number of coins and tokens on the new blockchain. Thus, situation 2 does not describe what would happen as a result of a hard fork in and of itself.

In reaction to the Ruling, many articles and briefings seem to have assumed implicitly that situation 2 (even if not technically precise) was intended to describe the taxation of the Bitcoin-Bitcoin Cash or Ethereum-Ethereum Classic splits.[19] However, upon a careful reading of the Ruling, we do not believe that this interpretation is clear. In fact, since situation 1 seems closest to describing how a contentious hard fork (including a new project hard fork) actually works, the opposite conclusion may be warranted, namely that no income is recognized upon the hard fork. Situation 2 seems closest to the hard fork-airdrop combination used in connection with the launch of Bitcore, which we understand to have been an unusual and rare combination.[20]

We therefore recommend that the Service issue further guidance clarifying how contentious hard forks should be taxed and address airdrops separately. In particular, we recommend revising the Ruling to focus situation 1 on a non-contentious hard fork and situation 2 on a contentious hard fork (without an airdrop).

A. How Should Hard Forks Be Taxed (in the Absence of Airdrops)?

1. Non-Contentious Hard Forks

We recommend that the Service clarify the important distinction between contentious and non-contentious hard forks. The FAQs already provide that soft forks do not have tax consequences.[21] Non-contentious hard forks represent software upgrades that are very similar to those resulting from soft forks, except that the modifications relate to core consensus rules on the network, making future transactions after the fork incompatible with transactions using the unmodified software. Where the entire network upgrades to the new system and the infrastructure supporting the unmodified version is dismantled, the effects of the non-contentious hard fork are the same as those of a soft fork.

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[19] Amy Lee Rosen, *IRS Clarifies Tax Treatment of Crypto Hard Forks, Airdrops*, LAW360 TAX, (Oct. 9, 2019), https://www.law360.com/articles; Robin Singh, *IRS Crypto Guidance Clarifies A Few Things for Investors*, LAW360 TAX, (Oct. 15, 2019), https://www.law360.com/articles/1209442/irs-crypto-guidance-clarifies-a-few-things-for-investors. Other commentators emphasized, however, that the Ruling does not match up with industry practice. *See* Michael Cohn, *IRS Continues Fight for Virtual Currency Information*, ACCOUNTING TODAY, (Dec. 3, 2019), https://www.accountingtoday.com/news/irs-continues-fight-for-virtual-currency-information; Kristen A. Parillo, *Cryptocurrency Needs Clarity, Lawmakers Say*, TAXNOTES, (Jan. 2, 2020), https://www.taxnotes.com/tax-notes-today-federal/cryptocurrency/cryptocurrency-guidance-needs-clarity-lawmakers-say/2020/01/02/2bqwm.

[20] *See supra* note 14. However, a recent article suggests that the Service may have used the term "airdrop" loosely and that the Ruling may reflect an endorsement of the Accession to Wealth approach outlined below. *See* David J. Shakow, *Taxing Bitcoin and Blockchains: What the IRS Told Us (and Didn't)*, TAXNOTES, (Jan. 13, 2020), at 249 n. 45, https://www.taxnotes.com/tax-notes-today-federal/cryptocurrency/taxing-bitcoin-and-blockchains-what-irs-told-us-and-didnt/2020/01/13/2bpx8 (referencing a conversation with the author of the Ruling).

[21] *Frequently Asked Questions on Virtual Currency Transactions*, Q29, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019).

With respect to non-contentious hard forks, we recommend treatment analogous to that of soft forks, since like soft forks such non-contentious hard forks represent an overall system upgrade and are not intended to result in two forked chains going forward.[22] Before the hard fork a holder owns one coin or token and after the hard fork it owns what is technically a new coin or token but is supported by the entire network infrastructure of the original coin or token. While the original coin or token still exists on the legacy chain, it has become impossible to transact on the legacy chain because the community no longer will support the legacy chain. Essentially a holder goes from owning one coin or token to owning an upgraded version of that coin or token. This could be said to be analogous to an update to software owned under a "shrink wrap" license,[23] and there appears to be no authority treating such an update as a taxable event. A non-contentious hard fork can also be viewed as an exchange of an old coin or token for a new coin or token that is not materially different in kind or extent.[24] While the software has been upgraded, nothing else has changed in that the same community and network infrastructure are supporting what is essentially the same coin or token.[25]

We would recommend that the coins on the new chain resulting from the non-contentious hard fork be treated as the continuation of the legacy coins (like coins after a soft fork) and thus retain the entire tax basis of the legacy coins. As a result, coins that remain on the legacy chain, in which it effectively becomes impossible to transact, should be treated as having a tax basis of zero. Should programmers in the future revive the legacy chain and create a new network infrastructure that makes transactions possible once again, a taxpayer retaining such legacy coins with a zero basis and subsequently transacting in them would then be taxed on any resulting gains to the full extent.

2. *Contentious Hard Forks*[26]

Leaving aside airdrops, which should not be conflated with hard forks, the question arises of how contentious hard forks should be treated for U.S. federal income tax purposes. Based on

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[22] We note that this conclusion may already be consistent with the Guidance if one reads Q&A 21 to apply to non-contentious hard forks. *Frequently Asked Questions on Virtual Currency Transactions, Q21*, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019).

[23] A "shrink wrap" license is a common software license that contains language to the effect that the end user agrees to the terms by opening the package. *Shrink Wrap License*, USLEGAL.COM, https://definitions.uslegal.com/s/shrink-wrap-license/ (last visited Jan. 21, 2020).

[24] Treasury Regulation Section 1.1001-1(a); *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991).

[25] *Weiss v. Stearn*, 265 U.S. 242 (1924) (no sale or exchange where new corporation organized in same state acquired all assets and liabilities and continued business of old corporation with same management; "mere change in the technical ownership of an enterprise"). For a detailed discussion of *Weiss* as well as cases finding a sale or exchange on other facts (including *United States v. Phellis*, 257 U.S. 156 (1921) and *Marr v. United States*, 268 U.S. 536 (1925), see New York State Bar Association Tax Section, *Report on Certain Corporate Reorganization Transactions Followed by "Same-State" Asset Drop-Downs*, (Report No. 1371, Jun. 5, 2017, *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2017/Tax_Section_Report_1371.html).

[26] As noted in Part I.B.2 above, the following discussion of contentious hard forks applies equally to hard forks that are used intentionally to jumpstart new cryptocurrency projects.

existing lines of authority, we believe there are four plausible ways of analyzing the consequences of a contentious hard fork.[27]

a. Accession to Wealth Approach

The first approach is to treat the split of the legacy chain (crypto M) into crypto M and crypto N and the resulting creation of an identical number of new units of crypto N on the new blockchain as an "accession to wealth, clearly realized"[28] once the taxpayer has complete dominion and control over new crypto N. As other commentators have noted,[29] this position finds support in the tax treatment of treasure trove and free samples, which generally give rise to taxable income upon discovery or receipt of an asset, however unexpected,[30] subject to the principle that a taxpayer must claim or exercise dominion and control over the asset.[31] The taxation of prizes offers further support.[32] The Service clearly adopted this position in connection with what it referred to as airdrops after hard forks, but it is not clear what position should be taken when the taxpayer or a service provider needs to take technically complex steps in order to make the new coins accessible. In the case of a hard fork, the taxpayer can use existing private keys to transact in the new coins but only after such steps are taken to make the new coins accessible. After hard forks, the taxpayer therefore does not have immediate access to, and control over, the asset in the account, as would be the case where cash is transferred to a bank account or securities are placed in a custodial account.

[27] Given the speed at which this technology is evolving, Treasury and the Service also could consider whether to permit taxpayers holding cryptocurrency to take any reasonable method consistently applied to questions of realization, timing, valuation and basis and requiring disclosure of the relevant method on the taxpayer's return. Any changes to these methods could then be treated as changes in accounting methods. If a taxpayer fails to disclose or to apply consistent methods, the Service could then apply its own reasonable method.

[28] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[29] Omri Marian and Kerri Ryan, et al., *Comments on the Tax Treatment of Hard Forks*, ABA Section of Taxation (Mar. 19, 2018); Peter J. Connors, *Taxing a Moving Target: Tax Issues Involving Cryptocurrency*, TAX REVIEW, (Nov. 12, 2018) *available at* https://media.orrick.com/Media%20Library/public/files/insights/taxing-a-moving-target.pdf.

[30] *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969) (cash found in old piano treated as income in year of discovery); *Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975) (taxpayer required to include value of free samples in income where he donated free samples and claimed charitable deductions for their value; court did not address what consequences of mere receipt would have been).

[31] *Haverly*, 513 F.2d at 226 ("intent to exercise complete dominion over unsolicited samples is demonstrated by donating those samples to a charitable institution. . . ."; donation of some samples occurred in tax year after receipt); GCM 36639 (Mar. 22, 1976) ("[I]t is clearly the position of the Service that the mere receipt of books does not constitute income. Rather, the inclusion of the value of the books in income is dependent on the taxpayer accepting them as his own. The taxpayer manifests this acceptance if he contributes the books to charity and claims a deduction therefor, sells them, or places the books in his own library.").

[32] *See* Section 74(a) & (b) (except for certain prizes and awards transferred to charities or received as a qualified scholarship, gross income includes amounts received as prizes and awards); Treasury Regulation Section 1.74-1(a)(1) ("prizes and awards which are includible in gross income include (but are not limited to) amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types. . . ."); Rev. Rul. 58-127, 1958-1 C.B. 42 (ruling that a taxpayer's gross income includes amounts received as prizes at the time the taxpayer has the power to procure the payment of such prize to another).

Under this approach, consistent with the Guidance as it relates to "hard forks followed by airdrops," a holder of the original cryptocurrency would recognize income equal to the fair market value of the new cryptocurrency at the time the new cryptocurrency is received or such later time as the taxpayer has dominion and control over the new coins and tokens. This result seems to fit well with the case of the Bitcoin-Bitcoin Cash fork where a network infrastructure and support from exchanges and wallet providers for Bitcoin Cash were available relatively quickly and holders had a tradable asset with material value after the hard fork.[33] In that case, a taxpayer who originally held bitcoin ended up owning two valuable assets in which it could transact.

On the flipside, while arguably theoretically appealing to take the view that new coins represent an accession to wealth similar to finding cash in a taxpayer's piano or receiving free samples, this approach does not fully take into consideration that the possibility of hard forks is intrinsic in public open source blockchain technology. The "new coins or tokens" become available at the time of the hard fork only to persons already owning the legacy coins or tokens. Implicit in the ownership of legacy coins or tokens is the possibility of owning new coins or tokens resulting from a hard fork. This necessary link to the original coin seems to distinguish new coins or tokens resulting from hard forks from unsolicited samples, treasure trove or prizes. Moreover, as discussed in Part III.B below, the Accession to Wealth approach raises a number of practical challenges in the context of many hard forks, which may make it difficult to administer and burdensome for taxpayers and the Service in a large number of cases.

Moreover, this approach can result in taxable income in excess of a taxpayer's economic gain as illustrated by the following example:

> Example 1. Taxpayer holds crypto X worth $1,000 before the fork with a basis of $500. After the fork, taxpayer holds the same crypto X (now with a value of only $300) plus new crypto Y (value of $800). On these facts, the aggregate value increased by $100. However, under the Accession to Wealth approach, taxpayer would have ordinary income of $800.

This result could be ameliorated by setting a cap on the income inclusion at an amount equal to the excess of the sum of the value of crypto X and crypto Y after the fork over the value of crypto X before the fork, or alternatively the excess of the sum of the value of crypto X and crypto Y after the fork over the taxpayer's basis in crypto X.

b. Basis Splitting Approach

The second approach is to treat the contentious hard fork as a non-realization event but to allocate the basis of each original coin between that coin and the new "mirror" coin. Support for this approach can be found in authorities regarding the distribution of subscription rights on

[33] SFox, *From Hard Fork to $4K: A Bitcoin Cash Price History*, MEDIUM. (Dec. 26, 2017), https://blog.sfox.com/from-hard-fork-to-4k-a-bitcoin-cash-price-history-311886390810; Jake Smith, *The Bitcoin Cash Hard Fork Will Show Us Which Coin Is Best*, FORTUNE, (Aug. 11, 2017), https://fortune.com/2017/08/11/bitcoin-cash-hard-fork-price-date-why/.

common stock[34] and authorities concluding that when property rights are subdivided, basis is allocated between the separate rights.[35] More generally, where multiple assets are acquired together but disposed of separately, basis is allocated based on fair market value at the time of purchase.[36] A line of authorities allocating the purchase price paid for a pregnant cow or mare between the animal and its offspring may also support treating a contentious hard fork as requiring a basis split between the original coin and the new coin, though this analogy may only be apt where a coin or token is acquired in anticipation of a contentious hard fork.[37] The foregoing authorities look to all facts and circumstances and generally would require a taxpayer to demonstrate which portion of its purchase price for the original coin or token was attributable to the new coin or token, which in practice may not be possible where a particular right or asset was not contemplated at the time of the original investment. At the time the original coin or token was purchased, any specific hard fork typically will not have been contemplated. An alternative principle for splitting basis would be to allocate basis based on relative fair market values at the time of the fork, such as in the case of stock dividends and spin offs under current law, though such an approach could require legislation.[38]

A further question arises as to when the basis allocation should occur. As in the case of the Accession to Wealth approach discussed above, the correct time for a basis allocation may be once the taxpayer has dominion and control over the new coins or tokens, such that the new coins or tokens have become an investment that is separate from the legacy coins or tokens.[39] However, it may also be appropriate to allocate basis only at the time when a taxpayer disposes of the coins or tokens either on the basis that the taxpayer only has dominion and control once it exercises dominion and control by disposing of the coin or token[40] or based on principles similar to basis

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[34] *Miles v. Safe Deposit & Trust Co. of Baltimore*, 259 U.S. 247 (1922) (basis allocated between stock and subscription rights based on cost basis in stock).

[35] *Gladden v. Commissioner*, 262 F.3d 851 (9th Cir. 2001) (at time of purchase land had no separately alienable water rights but subsequent change in law permitted separate sale of water rights; court concluded that basis should be allocated based on value of subdivided rights at time of original purchase; where taxpayer cannot demonstrate value of separate right, value and basis determined to be zero). *See also Reuben v. Comm'r*, No. 2:11-cv-09448-SJO-PJW, 2013 WL 656864 (C.D. Cal. 2013), *aff'd*, 628 Fed. Appx. 509 (9th Cir. 2016) (taxpayer receiving stock in demutualized insurance company in respect of insurance policy had zero basis because taxpayer did not establish amount "paid" for stock when acquiring policy).

[36] Treasury Regulation Section 1.61-6(a), Example 2.

[37] *Gamble v. Commissioner*, 68 T.C. 800 (1977) (allocating portion of purchase price of pregnant broodmare between broodmare and foal); Rev. Rul. 86-24, 1986-1 C.B. 80 (at birth calf takes basis equal to premium paid for cow being pregnant). *See also Metz v. United States*, 10 A.F.T.R. 2d 5443 (E.D. Ky. 1962) (where parties attributed no value to unborn foal when acquiring brood mare, no basis allocated to foal).

[38] *See* Section 307(a); Treasury Regulation Section 1.307-1(a); Section 358(b)(2); Treasury Regulation Section 1.358-2(a)(2)(i). We would note that such an approach would introduce many of the challenges regarding determination of fair market value discussed in Part III.B.2 below. However, those concerns could be mitigated with a rule similar to the rule in Section 307(b) and Treasury Regulations Section 1.307-2 providing for a basis of zero in a stock right that is worth less than 15% of the value of the old stock unless the taxpayer elects proportional allocation.

[39] *See DeCoppet v. Helvering*, 108 F.2d 787 (2d Cir. 1940) (taxpayer not permitted to take loss on subsidiary stock as long as such stock was stapled to parent stock).

[40] *Haverly*, 513 F.2d at 226 (taxable income in year taxpayer exercised dominion and control by donating books, not in year of receipt).

allocation in connection with bond stripping transactions.[41] Even then the question arises whether the basis split should be based on relative fair market values at the time the original coin or token is purchased, the time of the fork or the time of disposition.

We expect that in most cases the Basis Splitting approach under existing authorities would result in the new coin or token having a basis of zero because the taxpayer would be unable to demonstrate a basis for any other allocation. However, a different result may be obtained in situations where a taxpayer acquires a coin or token after a hard fork has been announced or based on its knowledge of and interest in a fork project. Those cases would then raise complex factual questions about how much of a premium is attributable to the expectation of a successful launch giving rise to new coins or tokens with material market value or other utility.

A conceptual weakness of the Basis Splitting approach is that the subdivision of property rights into land and separate water rights or the allocation of basis between a pregnant cow and its offspring upon birth by definition relates to a one-time event that lends itself to basis splitting. Hard forks, on the other hand, can and do occur repeatedly and, unlike the birth of offspring in connection with the purchase of a pregnant animal, often are not anticipated. Furthermore, in contentious hard forks within a single blockchain community, like the August 1, 2017 split of the Bitcoin blockchain, a drop in price of the original coin might be merely temporary, which seems to undercut the logic underlying basis splitting.[42] Similarly, where a hard fork is intended to jumpstart a new cryptocurrency, the creation of the new currency may have no effect on the value of the original coin and is intended to be unrelated to the original coins or tokens.

A virtue of the Basis Splitting approach, however, may be that it could provide a consistent basis for the taxation of contentious and non-contentious hard forks since upon a non-contentious hard fork the basis split (at least if made on the basis of current fair market values) should result in the allocation of the entire historic basis to the new coins or tokens, which represent the continuation of the original investment.

c. Zero Basis Asset Approach

The third approach would be to treat the contentious hard fork as a non-realization event and to treat the new coins or tokens as having a basis of zero.[43] This approach finds support in authorities treating the birth of livestock as not constituting a taxable event. When a taxpayer owns

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[41] *See* Section 1286(b)(3) (basis allocation based on fair market value immediately before stripping transaction). Unless based on the principles of *Haverly*, such an approach could require legislation.

[42] On August 1, 2017, the opening price of bitcoin was $2,871.30 USD and the closing price was $2,718.26 USD while on August 2, 2017, the opening price was $2,727.13 USD and the closing price was $2,710.67 USD. *About Bitcoin*, COINMARKETCAP, coinmarketcap.com/currencies/bitcoin (last visited Jan. 3, 2020). On August 1, 2017, the opening price of Bitcoin Cash was $294.60 USD and the closing price was $380.01 while on August 2, 2017, the opening price was $382.38 USD and the closing price was $452.66 USD. *About Bitcoin Cash*, COINMARKETCAP, coinmarketcap.com/currencies/bitcoincash (last visited Jan. 7, 2020).

[43] A variant of this approach would be to treat the hard fork as giving rise to an open transaction. *See generally Burnet v. Logan*, 283 U.S. 404 (1931); Rev. Rul. 58-234, 1958-1 C.B. 279, *clarified by* Rev. Rul. 68-151, 1968 C.B. 363). A holder would then only be taxed upon a disposition of the new coins or tokens. Unlike the Zero Basis Asset approach described above, however, this approach might result in ordinary income if it is treated as an "accession to wealth" equal to the fair market value of the new coin or token immediately before its disposition.

a cow or broodmare and has her bred, the taxpayer does not have taxable income upon the birth of the calf or foal and has a zero basis in the calf or foal (except to the extent it capitalizes breeding fees).[44] This approach finds further support in authorities applying non-realization treatment in other contexts where a taxpayer receives an item of some value based on its ownership or acquisition of another asset. For example, authorities conclude that the receipt of rights to purchase stock and debentures of one corporation based on a taxpayer's ownership of stock in a second corporation was not a taxable event and that the stock and debentures received had a basis of zero[45] and that discount coupons received in connection with purchases of airline tickets do not give rise to taxable income and have a basis of zero.[46]

As in the case of the foregoing authorities, the new coin or token can be obtained at inception of the hard fork only if the holder owns or acquires the original coin or token. The new coin or token is created out of the original coin or token. The birth of offspring from a taxpayer's existing herd of cattle or broodmares is a fitting analogy. The taxpayer owns the "parent" coin, which can be said to give birth to the new "baby" coin. Like breeding of livestock, multiple contentious hard forks (including in particular "new project" hard forks) can happen over time giving rise to different "baby" coins from the same "parent" coin and these hard forks do not necessarily diminish the value of the "parent."[47]

We would expect that this approach would be more easily administrable than the Accession to Wealth or the Section 1001 approach for the reasons discussed further in Part III.B below. Simplifying the recordkeeping and reporting process for taxpayers is likely to increase compliance, a key goal of the Service in this area. We would also expect this approach to be more administrable than the Basis Splitting approach, which could create uncertainty as to the proper allocation of basis for many years after the fork. Moreover, in practice, the Basis Splitting approach would lead to the allocation of zero basis to the new coin or token in many instances anyway. Holding an asset with a basis of zero would ensure that taxpayers are taxed in full at the time of a sale or exchange of the coins or tokens for cash, other property or services. At that time, the relevant value may be more easily ascertained. We recognize, however, that this approach would allow for the deferral of income -- potentially for long periods of time.

Moreover, it is possible that, after a contentious hard fork, the original chain withers. In such a case, a taxpayer would have a zero basis in the new coin or token, which then would have significant built-in gain, and a cost basis in its legacy coin or token, which then would have a significant built-in loss. The taxpayer could seek to recognize the loss on the legacy coin or token and defer income indefinitely on the new coin or token. We view this as an undesirable outcome

[44] I.R.S., Market Segment Specialization Program Audit Techniques Guides: Farmers (2011); *cf. Gamble*, *supra* note 37; *Metz*, *supra* note 37.

[45] Rev. Rul. 63-225, 1963-2 C.B. 339.

[46] Rev Rul. 79-431, 1979-2 C.B. 108. The Service similarly has concluded that receipt of the right to sell a designated amount of milk at a premium price (where that right was based on the prior milk production record) and the receipt of a gas ration coupon was not taxable. *See* GCM 37971 (Jun. 1, 1979).

[47] Amy Lee Rosen, *IRS Cryptocurrency Guidance Leaves Unanswered Questions*, LAW360 TAX, (Oct. 11, 2019), https://www.law360.com/articles/1208248/irs-cryptocurrency-guidance-leaves-unanswered-questions; Pete Rizzo, *Will Bitcoin Cash Impact the Bitcoin Price? Traders Split on Possible Fork*, COINDESK, (Jul. 31, 2017), https://www.coindesk.com/will-bitcoin-cash-impact-bitcoin-price-traders-split-possible-fork. *See also supra* note 44.

and would recommend that, if the Zero Basis Asset approach is taken, the Service provide that in the case of a sale of the legacy coin or token at a loss, the loss be denied and the amount of the disallowed loss increase the basis of the new coin or token. We note that legislation may be required to achieve this result. The Service may wish to provide for a limited loss disallowance period (such as five years) to simplify recordkeeping burdens, though we note that limiting the loss disallowance period in this way could permit taxpayers to recognize what are essentially artificial losses after the end of whatever period is chosen.

d. Section 1001 Approach

The fourth approach to the taxation of contentious hard forks may be to treat the hard fork as a sale or exchange of the original coin or token for both a deemed modified original coin or token and a new coin or token. The argument for sale or exchange treatment would be that, even though the original coin or token itself is exactly the same before and after the fork, the network infrastructure and community around the legacy chain and thus a kind of penumbra around the original coin or token that makes up part of the relevant "asset" has changed, such that the original coin or token as it functions in the relevant community is now different in a material way. It might be that the legacy chain has diminished support from miners, exchanges and wallet providers that migrate to or support the new chain over the legacy chain or it might be that the community around the legacy chain is stronger once disgruntled community members have started a new community around the new chain, but in either case, the original coin may be said to be different.

If this approach is taken, there would be a taxable sale or exchange at the time of the hard fork, resulting both in the recognition of gain or loss on the original coin or token and the allocation of the new fair market value basis between the original coin or token and the new coin or token. This approach would raise all the same practical concerns around timing of the taxable event and fair market value discussed in Part III.B below as are raised by the Accession to Wealth approach and certain Basis Splitting approaches. Moreover, since forks are easily created and holders may have limited visibility about impending contentious hard forks, triggering gain on the original coin or token may be a punitive result. However, this approach avoids the concerns relating to income deferral and misallocation of basis that arise under the Zero Basis Asset approach and provides a coherent basis for taxing both contentious and non-contentious hard forks.

Finding a sale or exchange in the context of a contentious hard fork, in which a taxpayer starts with one asset and ends up with what is technically the same asset and an additional asset, depends upon viewing the asset represented by a coin or token as including various externalities (such as community support, mining infrastructure, support from service providers) beyond the technical specifications of the coin or token itself. It is not clear that such an approach is correct. Moreover, the case law regarding sales and exchanges focuses on whether the legal entitlements of the holders are different in kind or extent,[48] and the legal entitlements of a holder with respect to the original coin have not changed.[49] In addition, a contentious hard fork is triggered by developers making changes to the software protocol and does not require any consent from holders

[48] *See Cottage Sav.*, 499 U.S. 554.

[49] It may be said that unlike shares of stock, bonds or other types of assets there are no "legal entitlements" embodied in a coin or token since it is merely code that exists on a blockchain. However, the holder's legal rights vis-à-vis use of the private keys to transfer the original coin or token have not changed either.

of coins or tokens whose only remedy to avoid the hard fork would be to sell the original coin or token. A contentious hard fork therefore functions more like a unilateral option on the part of the developers, which arguably should not give rise to a sale or exchange for the holders.[50] Moreover, given that hard forks are intrinsic features of the open source protocol underlying a cryptocurrency, each hard fork could be said to be pursuant to the terms of the original coin.[51]

Adopting the Section 1001 approach to hard forks could also lead to distortive results.

> Example 2. Taxpayer owns crypto X with a basis of $500 and a value of $1000 just before a hard fork. After the hard fork crypto X is worth $800 and crypto Y is worth $300. Under the Section 1001 approach, taxpayer has taxable gain of $600 (received value of $1100 minus basis of $500), even though its economic gain arising from the hard fork is arguably only $100.

> Example 3. The facts are the same as in Example 2 except that taxpayer has a basis in crypto X that is $1000. Under the Section 1001 approach, taxpayer has gain of only $100, which is less than the income inclusion that would be required under the Accession to Wealth approach.

The result in Example 2 could be ameliorated by setting a cap on the recognized gain at the value of the new coins received, or alternatively at the excess of the sum of the value of crypto X and crypto Y after the hard fork over the value of crypto X before the hard fork, but such a rule could require additional legislation.

B. Practical Challenges with Valuation and Dominion and Control

If the Service follows either the Accession to Wealth or Section 1001 approach outlined above and treats a contentious hard fork as giving rise to an accession to wealth that results in current taxable income or a taxable exchange (or adopts a basis split methodology based on current fair market values), it is critical to properly establish (1) the fair market value of the new coin or token at the relevant time and (2) when the taxpayer has complete "dominion and control" over the new coin or token. In the case of cryptocurrency, establishing both of these facts can be fraught with difficulty. Since the income inclusion or other taxable event (and thus the need to determine fair market value) would occur at the time the taxpayer is said to have complete dominion and control over the new asset, we will examine "dominion and control" first.

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[50] *Cf.* Treasury Regulation Section 1.1001-3(c)(3)(ii) (with respect to debt instruments, a unilateral option that does not require consent of the other party, a related person under Section 267(b) or Section 707(b)(1), or a court or arbitrator does not constitute a modification); Rev. Rul. 57-535, 1957-2 C.B. 513 (no exchange where holder exercises unilateral option to change terms of instruments). This may distinguish a contentious hard fork from a non-contentious hard fork where there is more generalized support from the overall community, including holders. But while a non-contentious hard fork may feel more consensual, actual holder consent is not required.

[51] *Cf.* Treasury Regulation Section 1.1001-3(c)(1)(ii) (with respect to debt instruments, alterations pursuant to the terms of the instrument generally are not modifications); Rev. Rul. 87-19, 1987-1 C.B. 249 (change in interest rate pursuant to adjustment clause would not result in Section 1001 exchange).

1. Dominion and Control

With respect to new cryptocurrency received in an "airdrop after a hard fork" the Guidance states that a taxpayer has "dominion and control" over the new cryptocurrency at the time it "can transfer, sell, exchange or otherwise dispose of" the cryptocurrency," which is said generally to be "the date and time the airdrop is recorded on the distributed ledger."[52] If the Service follows the Accession to Wealth or Section 1001 approach, we expect it would apply the same principle to contentious hard forks more generally. We also note that the Guidance seems to go beyond the conclusion in *Haverly*, where the court found dominion and control at the time the taxpayer actually donated the free samples rather than at the time of receipt when it could have "transacted" in them.[53] Given the nature of cryptocurrency, the timing at which a taxpayer obtains the requisite control will depend upon the manner in which the taxpayer holds the cryptocurrency.

a. Exchanges or Other Hot Wallets

If a taxpayer holds the original cryptocurrency on an exchange or in another hot wallet supported by a third party service provider, generally the earliest time at which it can be said to obtain "dominion and control" over the new cryptocurrency is when the wallet provider or exchange takes the necessary technical steps to support the new cryptocurrency. Even then it may not be possible for a taxpayer actually to transact in the new coins or tokens since the taxpayer still may not be able to send or receive the new coins or tokens on the same platform. All the exchange or wallet may "support" is moving the new coins out of the exchange or wallet and another exchange or platform may not be readily available to the taxpayer. This raises the question of what affirmative steps a taxpayer needs to take to obtain "dominion and control," a topic we discuss in Part III.B.1.c below. In some instances all that may be required is to download new software, while in other cases a taxpayer may need to move the new coins or tokens to an exchange somewhere in the world that would permit transactions in that new coin or token.

For taxpayers that hold their original coins on an exchange or in another kind of supported hot wallet, the further question arises of what happens if an exchange or wallet provider never supports the new cryptocurrency for its customers. This could happen if the exchange or wallet provider fails to take any technical steps required to obtain access to the new cryptocurrency, for example because it decides that it is not worth the effort to incur the expense necessary to obtain access to a new coin or it determines that the disclosure provided by the new cryptocurrency's development team is below industry standards of security and competence. In that case, it would seem that there should never be an income event for the customers since they never obtain "dominion and control." Moreover, an exchange or other custodial wallet provider could make the necessary upgrades but decide not to make the new cryptocurrency available to its customers and to use the new cryptocurrency for its own purposes, using its control over private keys to the

[52] *Frequently Asked Questions on Virtual Currency Transactions, Q24*, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019).

[53] *Haverly*, 513 F.2d at 227 ("To decide the case before us we need only hold, as we do, that when a tax deduction is taken for the donation of unsolicited samples the value of the samples must be included in the taxpayer's gross income," requiring income inclusion in 1968 despite taxpayer receiving some samples in 1967).

legacy coins held by the exchange or wallet provider to achieve that end.[54] We would recommend that the Service provide further guidance on how taxpayers will be treated in these circumstances.

b. Other Types of Wallets

For taxpayers that do not hold their cryptocurrency through an exchange or software wallet provider, the discussion of airdrops in the Guidance states that a taxpayer generally has dominion and control when the transaction (in this case, the hard fork) is recorded on the distributed ledger, provided the taxpayer has the ability to transact in the coins or tokens.[55] As discussed in Part I.B.4 above, it is not entirely clear when the hard fork can be said to have occurred even if the location, date and time can be observed on the distributed ledger after the fact: at the time the "snapshot" of the legacy chain is taken, upon the first visibility of the new protocol on the network or upon the first block being mined creating the beginning of the actual new chain. The latter may be most consistent with the Guidance, which seems to focus on the time a transaction is recorded on the distributed ledger, but raises some uncertainty about how to treat the transactions in the first block. Of potentially greater practical relevance is the question of when a taxpayer holding its legacy coins in a cold wallet or in another manner that is not supported by a third party can be said to be able to transact in the new coins after the hard fork. Unless such taxpayers are programmers themselves or a trustworthy software application is made available by a wallet provider, they may need to hire programmers to perform the necessary upgrades to give them access to the new coins, thereby incurring costs and potentially running the risk that the programmers they hire could abscond with their private keys.

c. What Steps Do Taxpayers Need To Take?

As discussed above, taxpayers do not "receive" new coins after a hard fork. Instead, they or the service providers through which they hold their legacy coins need to take certain steps to obtain access to these new coins. This raises the question of when a taxpayer using the cash method of accounting would be considered in "constructive receipt" of the new coins. Under the doctrine of "constructive receipt" a taxpayer cannot turn its back on an asset or income stream to avoid taxation.[56] For example, receipt of a salary check is taxable whether it is cashed or not.[57] A

[54] Taking the new coins in this manner may be a breach of the exchange's agreement with its customers but technically there is nothing to prevent an exchange from doing so. In that case, should the customers be said to recognize income followed by an immediate theft of the new coins or tokens if the exchange uses them for its own account contrary to its agreement with the customers?

[55] *Frequently Asked Questions on Virtual Currency Transactions*, Q23 & Q24, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019).

[56] Treasury Regulation Section 1.451-2(a) (constructive receipt requires a mature right including the power to collect upon demand); *Ross v. Commissioner*, 169 F.2d 483, 492 n.6 (1st Cir. 1948) ("The doctrine of constructive receipt treats as taxable income which is unqualifiedly subject to the demand of a taxpayer on the cash receipts and disbursements method of accounting, whether or not such income has actually been received in cash."); *United States v. Fletcher*, 562 F.3d 839 (7th Cir. 2009) (holding that a taxpayer is in constructive receipt of restricted stock held in escrow on date of deposit because she received full economic benefit at that time). *But see* Treasury Regulation Section 1.451-2(a) ("[I]f a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.").

[57] *E.g.*, *Walter v. United States*, 148 F.3d 1027 (8th Cir. 1998) (a check received in 1986 but lost before it was negotiated is taxable income in 1986 even though taxpayer did not deposit funds until 1988); *Bright v. United*

taxpayer is not in constructive receipt, however, if there are substantial restrictions and limitations on its ability to receive the income.[58] Similarly, where a cash basis taxpayer receives a note in payment for property, it is only taxed to the extent the note is a "cash equivalent," *i.e.* is assignable and marketable and thus has ascertainable value.[59] For accrual method taxpayers, income recognition occurs when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[60] Assuming reasonable accuracy is not at issue, an accrual taxpayer's right to income is fixed when it is paid, due or earned, whichever occurs first.[61] However, certain conditions precedent[62] and the uncertainty of payment may prevent the taxpayer's right from becoming "fixed."[63]

As noted above, in most instances a taxpayer will need to take some affirmative steps to obtain dominion and control over new coins, even if it holds legacy coins on an exchange or in a software wallet. To the extent those steps are ministerial, like downloading a software upgrade made available by the exchange or wallet provider, we do not see those steps as representing substantial restrictions or conditions that ought to stand in the way of finding current dominion and control and thus concluding, under the Accession to Wealth approach, that the taxpayer should recognize income at the time it could take those steps.[64] But at what point do the required steps cease to be ministerial? For taxpayers on exchanges or using wallets that only support withdrawal of the new coins, is such a taxpayer in constructive receipt if it would be able to find, and obtain access to, an exchange that permits trading in the new coins even if the taxpayer does not do so? And if so, would the taxpayer be in constructive receipt if the only available exchange is

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States, 926 F.2d 383 (5th Cir. 1991) (a check does not fail to qualify as cash equivalent simply because it is large in amount and, allegedly, less marketable); *Fong v. Commissioner*, 48 T.C.M. 689 (1984) (date of actual or constructive receipt controlled, not date of deposit), *aff'd without opin.*, 816 F.2d 684 (9th Cir. 1987); *Kahler v. Commissioner*, 18 T.C. 31 (1952) (holding that a taxpayer was taxable in the present year upon receipt of a check on December 31 even though received after banking hour).

[58] Treasury Regulation Section 1.451-2(a); *see Nesbitt v. Commissioner*, 43 T.C. 629 (1965); *Bizzack Bros. Construction Corp. v. Commissioner*, 41 T.C.M. 175 (1980); PLR 8151114 (requirement of securing the other firm's consent was a substantial limitation); Rev. Rul. 80-300, 1980-2 C.B. 165 ("a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to make inapplicable the doctrine of constructive receipt").

[59] *See, e.g., Joyner Family LP v. Commissioner*, T.C. Memo 2019-159 (2019).

[60] Section 451(b)(1)(C).

[61] *See Schlude v. Commissioner*, 372 U.S. 128 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127 .

[62] *See, e.g., Standard Lumber Co. v. Commissioner*, 35 T.C. 192 (1960) (conditional right to receive interest or principal on debentures was conditional on payment of revolver requiring payment on revolver before accrual).

[63] *See Koehring Co. v. United States*, 421 F.2d 715 (Ct. Cl. 1970) (holding that at the time the royalties accrued, the taxpayer has a "reasonable expectancy" of payment); *Harmont Plaza v. Commissioner*, 64 T.C. 632, 649 (1975) (stating that "cash flow and priority provisions countenance the possibility of delay in actual receipt but … in no way diminish [the taxpayer's] underlying right to receive. The law is clear that postponement of payment alone does not defer accrual,' and that the question was 'whether the cash flow and priority schedule factors rendered payment sufficiently doubtful so as to warrant nonaccrual,' distinguishing the situation of a 'specific condition precedent' to the right to receive").

[64] Similarly, that would seem to be the correct time to treat the exchange as taking place under the Section 1001 approach or to split basis based on current fair market value (if that approach to basis splitting were chosen).

unregulated and based in a foreign jurisdiction?[65] For taxpayers holding legacy coins in a cold wallet that is not supported by a third party, is the taxpayer in constructive receipt if it would be required to hire programmers to perform the necessary upgrades in order to gain access or would the costs and risks involved constitute "substantial restrictions and limitations" or make the coins and tokens not assignable or marketable?

We believe that, if Treasury and the Service opt for the Accession to Wealth or Section 1001 approach (or even the Basis Splitting approach) to taxing contentious hard forks, these questions should be addressed. We recognize that beyond obviously ministerial steps (such as downloading software available to all account holders on a particular exchange or wallet holders using a particular software wallet), it may be difficult to delineate what steps would be considered sufficiently substantial such that a taxpayer's failure to take them would not be considered to be turning the taxpayer's back on new coins available after a hard fork. Any bright-line rule may be open to manipulation. But taxpayers would benefit from greater clarity about what steps constitute a sufficient burden that current taxation does not apply.

We also note that a rule based on "dominion and control" will result in different taxpayers recognizing income from the same contentious hard fork at different times. It can also cause a single taxpayer holding coins and tokens in multiple wallets on different exchanges as well as off-line to recognize income from the same contentious hard fork at different times in its different wallets. The former result seems inevitable and not necessarily problematic. The latter, however, will likely complicate a taxpayer's recordkeeping requirements and as a result make the movement of cryptocurrency between wallets, which the FAQs confirm is tax-free,[66] more cumbersome.

2. *Determination of Fair Market Value*

The Guidance provides that when a taxpayer "receive[s] cryptocurrency from an airdrop following a hard fork" it recognizes ordinary income equal to the fair market value of the new cryptocurrency at the time the transaction is recorded on the distributed ledger, provided the taxpayer has dominion and control over the cryptocurrency.[67] Ignoring the reference to airdrops after hard forks (for the reasons discussed above), the same principle presumably would apply if

[65] Many participants in cryptocurrency markets are wary of exchanges and similar platforms and concerned about the safety of assets held there given well-publicized cases raising questions about the integrity and security of various platforms. Erica Alini, *Founder of Crypto Exchange Quadriga Moved Users' Funds to Personal Accounts: Ernst & Young*, GLOBAL NEWS, (Jun. 20, 2019), https://globalnews.ca/news/5411298/quadriga-cotten-customer-funds-personal-accounts-ernst-young/ (founder, 30, died suddenly in India being the only one with access to the passwords to $188 million worth of cryptocurrency); Daniel Cawrey & Sina Nader, *Want Understand Bitfinex? Understand Mt. Gox*, COINDESK, (Apr. 30, 2019), https://www.coindesk.com/want-to-understand-bitfinex-understand-mt-gox (a leak in an online cryptocurrency wallet turned the largest cryptocurrency exchange bankrupt); Daniel Z. Morris, *Bitgrail Cryptocurrency Exchange Claims $195 Million Lost to Hackers*, FORTUNE, (Feb. 11, 2018), https://fortune.com/2018/02/11/bitgrail-cryptocurrency-claims-hack/ (following suspicious moves by the founder of the exchange, there was widespread skepticism behind an alleged hack claimed to have occurred).

[66] *Frequently Asked Questions on Virtual Currency Transactions*, Q37, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019).

[67] *Frequently Asked Questions on Virtual Currency Transactions*, Q23, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019).

Treasury and the Service take the Accession to Wealth or Section 1001 approach to contentious hard forks (or were to implement a basis split based on current fair market values). Given the need for someone to take affirmative steps to access new coins after a hard fork, fair market value, in practice, likely would be determined once a taxpayer has (or is deemed to have) dominion and control over the new coins – rather than at the time of first detectability of the hard fork.

The Guidance suggests that a taxpayer is required to report the value reported on the exchange where its account is located since it presumably could try to realize that value by selling on that exchange.[68] More generally, if a transaction is facilitated by an exchange but not recorded on the distributed ledger or is otherwise off chain, the fair market value is the trading price on the exchange at the date and time the transaction would have been recorded on the ledger if it had been on-chain.[69] With respect to holdings of cryptocurrency outside of an exchange, the FAQs state that fair market value is determined at the date and time the transaction is recorded on the distributed ledger[70] and go on to say that fair market values are determined based on cryptocurrency or blockchain "explorers" that analyze worldwide indices and calculate values for an exact date and time.[71]

While the foregoing rules regarding determination of fair market value appear simple, an accurate determination of fair market value for cryptocurrencies, and in particular new coins and tokens, is very challenging, in part because of a lack of support by credible established marketplaces. Different exchanges routinely report different values for the same cryptocurrency due to liquidity and other conditions internal to a particular exchange.[72] For a given U.S. taxpayer, this can be exacerbated by the fact that exchanges in many jurisdictions report prices in currencies other than the U.S. dollar, so that U.S. taxpayers with access to foreign cryptocurrency marketplaces may be able to simultaneously transact in a particular cryptocurrency at significantly different U.S. dollar values because of inflation and other conditions relating to the local jurisdiction's currency. Moreover, given low trading volumes on many exchanges, especially for

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[68] *Frequently Asked Questions on Virtual Currency Transactions, Q25*, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019). We would note that given low liquidity on many exchanges, especially for new coins, it is unclear whether a taxpayer could in fact realize that price upon an actual sale.

[69] *Frequently Asked Questions on Virtual Currency Transactions, Q25*, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019). It is important to note that generally only deposits with and withdrawals from an exchange are on-chain transactions, whereas all trading on the exchange is reflected only on the books and records of the exchange and does not correspond to transactions on the actual blockchain.

[70] *Frequently Asked Questions on Virtual Currency Transactions, Q24*, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019). For hard forks, it is unclear when precisely that occurs and, moreover, that point in time is likely well before the time when a taxpayer actually has dominion and control over the new coin or token.

[71] *Frequently Asked Questions on Virtual Currency Transactions, Q26*, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019).

[72] As of January 2, 2020 at 2:31pm, Bitcoin is valued at a price of $7,344.76 on BitMart but at a price of $7,313.55 on Fatbtc. *About BitMart*, COINMARKETCAP, https://coinmarketcap.com/exchanges/bitmart/ (last visited Jan. 3, 2020, 2:31 PM); *see also Fatbtc*, COINMARKETCAP, https://coinmarketcap.com/exchanges/fatbtc/ (last visited Jan. 3, 2020, 2:31 PM).

newly supported coins and tokens, even one relatively small transaction may significantly impact the trading price, calling into question whether the quoted price actually represents fair market value.[73] There are also widespread concerns with respect to many exchanges about whether prices reflect real transactions or whether trading volumes are faked.[74] Finally, while trading in cryptocurrencies occurs globally, individual market participants' access can be fractured depending upon which platforms and service providers are available locally for regulatory and other reasons.[75] All of these factors raise questions about how to determine a single fair value for a given coin or token.

Where a taxpayer does not hold cryptocurrency on an exchange, the Guidance's method for determining fair market value presents the further concern that blockchain explorers primarily provide transaction information in the native currency of a given blockchain. Information about prices in a government-issued, or "fiat", currency,[76] is imported from third party pricing sources.[77] It is unclear whether prices reported in this way constitute a fair or accurate representation of value. Many (if not most) exchanges and pricing sources that would be picked up by an explorer are unregulated and, as noted above, price manipulation and fraudulent trading practices are widely suspected to occur on certain exchanges. Importantly, participants in the industry do not rely on such an "explorer value." Instead, a widely used price source for portfolio valuation by U.S. market participants, such as hedge funds, other asset managers and their auditors, is the daily closing price reported by www.coinmarketcap.com. The prevailing global market convention is to use midnight UTC time as the beginning of each trading day. Using the "date and time" of a transaction, as suggested by the Guidance, therefore is not consistent with market practice. Moreover blockchain explorers that import pricing information generally provide current trading prices rather than minute-by-minute historic pricing information.[78]

The degree of difficulty in determining an accurate fair market value of new coins or tokens will depend in significant part upon what standards Treasury and the Service apply to determine when a taxpayer has dominion and control over new coins or tokens. If, subject to taking only simple steps like downloading broadly available software, a taxpayer has dominion and control

[73] Marija Rousey, *Best Bitcoin & Crypto Liquidity Providers 2019*, CHANGELLY, (Oct. 24, 2019), http://changelly.com/blog/best-bitcoin-crypto-liquidity-providers-2019/.

[74] Anna Irrera, *Cryptocurrency Exchanges At Risk of Manipulation: Report*, REUTERS, (Sep. 18, 2018), https://www.reuters.com/article/us-cryptocurrency-exchanges/cryptocurrency-exchanges-at-risk-of-manipulation-report-idUSKCN1LY2UG; Paul Vigna and Alexander Osipovich, *Bots Are Manipulating Price of Bitcoin in 'Wild West of Crypto'*, THE WALL STREET JOURNAL (Oct. 2, 2018), https://www.wsj.com/articles/the-bots-manipulating-bitcoins-price-1538481600.

[75] For example, based on the law of an exchange's home jurisdiction, an exchange may limit access to persons who are based in specific jurisdictions. A number of large non-U.S. exchanges ban U.S. persons from transacting so as not to potentially become subject to U.S. law.

[76] The term "fiat currency" is commonly used in the cryptocurrency industry and is generally defined as "[a] government-issued currency that is not backed by a physical commodity with intrinsic value, such as gold or silver." *See* James Chen, *Fiat Money*, INVESTOPEDIA, (Sep. 2, 2019), https://www.investopedia.com/terms/f/fiatmoney.asp.

[77] Examples of blockchain explorers that import third party pricing information include https://etherscan.io and https://ethplorer.io for the Ethereum blockchain and https://www.cryptocompare.com/ for the Bitcoin blockchain explorer (https://www.blockchain.com/explorer).

[78] Services provide minute-by-minute historic pricing information, such as https://www.tradingview.com/symbols/BTCUSD/ or https://cryptowat.ch.

only when it can actually transact in the new coins or tokens, it is likely that the determination of fair market value will occur at a time when there is already significant network support for the new coin or token. At that point in time, multiple pricing sources may be available and a taxpayer may have better access to a price at which it could actually transact. If, on the other hand, the threshold for constructive receipt is lower (for example deeming a taxpayer to have dominion and control and thus income recognition at a time when it could take more technically advanced steps like compiling its own software where the underlying code is available), then investors holding cryptocurrency in a cold wallet or another manner not supported by third party service providers could end up being taxed at a time when limited network infrastructure is available and potentially the only quoted value is on a foreign exchange where the taxpayer may be unable to transact in practice. We also note, that if a taxpayer has multiple accounts on multiple exchanges, different fair market values would often apply under this approach, making record keeping more burdensome.

In light of the challenges in accurately determining fair market value, if Treasury and the Service decide to proceed with an approach to contentious hard forks that requires a determination of the current fair market value of new coins, we would recommend that the Service study how best to develop criteria for identifying reliable pricing sources.[79] We would also recommend that the Service consider whether to allow reliance on an average price across multiple exchanges or on prevailing market conventions, such as the daily closing price. We further note that determining fair market value of cryptocurrency is relevant in many areas beyond valuing new coins after a contentious hard fork and thus merits continued study regardless of what approach is ultimately taken to contentious hard forks.

3. *Viability of Hard Forks and/or De Minimis Rule*

If the Service pursues the Accession to Wealth or Section 1001 approach to contentious hard forks, we would recommend that it study whether a concept of "viability" of a contentious hard fork should be included. Income recognition would then occur no earlier than when a new fork is considered "viable." To minimize abuse, this should be an objective measure, such as a set time period from the occurrence of the hard fork (measured from the point of the "snapshot" of the legacy chain, from the point of first detectability on the blockchain or from the first mined block on the new chain) or a specified number of blocks having been mined on the new chain. The Service should study this concept and consult with technical experts to determine the appropriate measure for viability.

How significant a concept of "viability" would be will depend in part upon how low the threshold for finding dominion and control is. In practice, the point of viability may occur once a significant number of exchanges and wallet providers start supporting the new coin or token, which, depending on the test for dominion and control, might coincide with the time at which persons with accounts on those exchanges or using those wallets generally would have dominion and control. Thus, a viability test could result in a more uniform timing for the inclusion of taxable income, as persons holding cryptocurrency in cold or otherwise unsupported wallets would be

[79] Such guidance could take an approach similar to Treasury Regulations Section 1.1273-2(f) for "publicly traded" debt instruments. It could also provide that certain categories of exchanges, such as those subject to regulation at a national, state or provincial level, are per se considered reliable.

required to include income only at the time of viability and those holding cryptocurrency in supported hot wallets (including exchange wallets) would be required to include income at the time their wallets or exchanges permit them to transact in the new coins or tokens.

In addition or as an alternative, the Service should consider a *de minimis* rule establishing that taxpayers do not need to report income where new coins or tokens resulting from a contentious hard fork have a value below a specified threshold. Such a threshold could be based on the average prices on the top exchanges (by volume or liquidity) supporting those coins. We recommend that Treasury and the Service study how best to establish such a threshold. In order to prevent taxpayers from failing to report subsequent transactions in those coins if and when their value increases, the Service could require at least domestic exchanges and wallet providers to information report the number of coins or tokens owned by U.S. persons once the exchange or wallet provider supports such new coins or tokens.

IV. TREATMENT OF MARKETING AIRDROPS / GIVEAWAYS

As discussed above, airdrops are not generally associated with hard forks. However, airdrops (or giveaways) are relatively common occurrences and guidance on the tax consequences of airdrops (or giveaways) is needed. In the following discussion, we will refer to these kinds of transactions as "giveaways" to avoid confusion with the Ruling's use of the term "airdrop." As described in Part I.C above, giveaways usually occur for marketing purposes and recipients of coins and tokens in a giveaway might not have control over whether they receive the new coins or tokens. In some cases, the coins and tokens can be used immediately, but often an exchange wallet will not permit immediate withdrawals or recipients need to take specified actions to obtain the new coins or tokens. Moreover, while not technically related to a particular legacy blockchain in the same way as a new coin or token that is obtained via a hard fork, holdings of a particular cryptocurrency may be a necessary qualification for obtaining a giveaway of a new and different coin or token.

In November, representatives of the Service stated publicly that Treasury and the Service have not yet determined how to treat giveaways.[80] We commend the Treasury and the Service for continuing to study giveaways. However, based on the logic of the Ruling, we believe it is difficult to distinguish typical marketing giveaways from what the Ruling refers to as "airdrops" after hard forks since in both instances a new asset is "received." Following the approach of the Ruling, coins and tokens distributed in a giveaway should give rise to ordinary income equal to their fair market value upon receipt, provided the taxpayer has "dominion and control" over the giveaway coins and tokens. Applying this approach to giveaways would raise many of the same challenges we discussed in Part III.B above regarding the determination of fair market value of the coins or tokens as well as whether a taxpayer has "dominion and control" over the coins or tokens. If Treasury and the Service take this approach, we recommend a *de minimis* threshold below which no income needs to be reported. We also recommend that at least in situations where coins or

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[80] Lydia O'Neal, *IRS Still Undecided on Taxation of Promotional Crypto Airdrops*, BLOOMBERG TAX, (Dec. 12, 2019), https://www.bloomberglaw.com/product/tax/document/X510PKHK000000?bna_news_filter=daily-tax-report&jcsearch=BNA%2520000016e1b5ede3ead6efbfd4900001#jcite; Allyson Versprille, *IRS Official Says Pre-2018 Crypto Exchanges Aren't 'Like-Kind'*, BLOOMBERG TAX, (Nov. 13, 2019), https://news.bloombergtax.com/daily-tax-report/irs-official-says-pre-2018-crypto-exchanges-arent-like-kind.

tokens are forfeited unless specific actions are taken within the giveaway period, no income be recognized until those actions are taken and, if those actions are never taken within the giveaway period, no income be recognized at all.[81]

Alternatively, Treasury and the Service could treat coins or tokens distributed in a giveaway as not giving rise to ordinary income upon "receipt" and instead treat those coins as having a zero basis.[82] That position could be based upon the fact that a taxpayer generally will only receive coins or tokens in a giveaway if it already owns other coins or tokens and upon the authorities discussed in Part III.A.2.c in connection with the Zero Basis Asset approach to contentious hard forks, though the analogies appear more tenuous in connection with giveaways.

In either case, the Service could require persons facilitating the distribution of coins or tokens in a giveaway, such as domestic exchanges or other service providers with access to "know your customer" information about customers,[83] to report the distribution of coins and tokens to the Service to create a record of the giveaway and help ensure that tax is reported either upon receipt or upon a subsequent sale or exchange of the coins or tokens for cash, other property or services.

While we do not recommend a specific approach to the taxation of giveaways, we recommend that if Treasury and the Service treat coins available after a contentious hard fork as "accessions to wealth," they also treat coins received in giveaways as accessions to wealth.

V. REPORTING OF CRYPTOCURRENCY ASSETS

A. General Reporting Requirements

The Service continues to be concerned about underreporting of cryptocurrency transactions.[84] We agree that additional guidance on reporting obligations is urgently needed. We commend the Service on releasing updated Schedule 1 to Form 1040 asking taxpayers whether

[81] Such a rule would be consistent with guidance that taxpayers are taxed on unsolicited receipts of property or treasure troves only if they keep the asset received or found. *See* Treas. Reg. 1.61-14(a) (treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession); *Glenshaw Glass Co.*, 348 U.S. 426; *Haverly*, 513 F.2d 224; GCM 36639; *see also* I.R.S. Publication 525 ("Found property. If you find and keep property that doesn't belong to you that has been lost or abandoned (treasure trove), it's taxable to you at its FMV in the first year it's your undisputed possession.").

[82] We note that the United Kingdom treats giveaways as resulting in new assets with a basis of zero and treats hard forks as non taxable events requiring a fair and equitable basis split. *Cryptoassets: Tax For Business* (section on Blockchain Forks), GOV.UK (updated Dec. 20, 2019), https://www.gov.uk/government/publications/tax-on-cryptoassets/cryptoassets-tax-for-businesses#contents.

[83] The blockchain developers giving away coins and tokens generally only have access to blockchain data that does not include identifying information regarding the owners of recipient addresses, which would make it impossible for them to information report.

[84] Alan Winston Granwell, *Virtual Currency: The Taxman Is Coming*, HOLLAND & KNIGHT, (Dec. 4, 2019), https://www.hklaw.com/en/insights/publications/2019-12/virtual-currency-the-taxman-is-coming.

they received, sold, sent, exchanged or otherwise acquired a financial interest in any virtual currency. This step should enhance compliance by individual taxpayers.[85]

We understand that Treasury and the Service are working on additional guidance on information reporting under Section 6045.[86] While we do not address Section 6045 reporting here, we are supportive of this project. It would seem that the broad authority with respect to "financial instruments" set forth in Section 6045(g)(3)(B)(iv) provides Treasury and the Service authority to require basis reporting with respect to cryptocurrency.

In addition, regardless of which approach is taken to contentious hard forks and giveaways, we recommend that the Service study whether to require at least domestic exchanges and wallet providers[87] to report to the Service the number of coins and tokens (with relevant identifying information) that become available to a taxpayer in such cases in order to facilitate compliant reporting upon receipt or at the time the coins or tokens are subsequently exchanged for cash, other property or services.

We also recommend that the Service confirm that IRS Form 8300, titled "Report of Cash Payments Over $10,000 Received in a Trade or Business," does not apply to payments received in cryptocurrency since cryptocurrency is not cash for U.S. federal income tax purposes.[88] We would, however, suggest that the Service consider whether a new reporting requirement similar to IRS Form 8300 on which businesses would report receipt of cryptocurrency with a value in excess of a specified U.S. dollar threshold would be a valuable tool to enhance compliance. If so, the Treasury and the IRS should seek any necessary legislation.[89]

B. Foreign Asset Reporting

Offshore tax avoidance has been a long-standing concern of the Service and, as noted above, over the last few years tax avoidance with respect to cryptocurrency transactions has become a focus as well. We therefore believe that guidance in the area of foreign asset reporting with respect to cryptocurrency is urgently needed.

[85] Form 1040/1040SR: *Additional Income and Adjustments to Income*, 2019, IRS http://www.irs.gov/pub/irs-pdf/f1040s1.pdf (last visited Dec. 24, 2019).

[86] Joshua Rosenberg, *Crypto Compliance Guidance In The Works, Top IRS Atty Says*, LAW360, (Oct. 17, 2019), https://www.law360.com/articles/1210498/crypto-compliance-guidance-in-the-works-top-irs-atty-says; Allyson Versprille, *IRS Hopes to Tackle Information Reporting in Next Crypto Guidance*, BLOOMBERG TAX, (Oct. 17, 2019), https://news.bloombergtax.com/daily-tax-report/irs-hopes-to-tackle-information-reporting-in-next-crypto-guidance.

[87] Subject to the discussion of FATCA (as defined below) in Part V.B.3 below, the Service would have to consider whether it has jurisdiction to require non-U.S. service providers to perform any reporting functions. The reporting contemplated here generally would be different from standard FATCA reporting.

[88] Notice 2014-21, 2014-16 I.R.B. 938, Q1 (providing that cryptocurrency is property and not cash for U.S. federal income tax purposes).

[89] Existing Section 6050I might provide authority for requiring reporting of cryptocurrency transactions below $10,000 on the basis that Section 6050I treats a "monetary instrument" with a face amount of not more than $10,000 as cash and cryptocurrency might be so characterized within the meaning of Section 6050I(d)(2). However, in that case the statutory threshold for reporting of $10,000 may not be met and one could debate whether cryptocurrency is a "monetary instrument". Moreover, transactions below $10,000 are likely of less interest to the Service.

Before discussing the application of existing rules on foreign asset reporting to cryptocurrencies, we will provide some background on when cryptocurrency may be said to be held outside the United States as well as why cryptocurrency may be held outside the United States. For an asset that by definition does not exist in physical form and exists on a distributed ledger copies of which are held on computers all over the world, it is difficult to determine physical location in a meaningful way. Moreover, as discussed above, coins and tokens only exist on the blockchain, so an investor never actually holds the coins or tokens themselves. All an investor, trader or other market participant owns are rights to control, transact in and move the coins or tokens from one address on the blockchain to another through its control of the private keys. As discussed above, taxpayers that hold cryptocurrency on an exchange do not have control of the private keys associated with their balances of cryptocurrency. All private keys to cryptocurrency held by the exchange are controlled by the exchange and taxpayers merely have claims against the exchange.

Given the significance of the private keys, the "physical location" of a coin or token could be considered to be where a particular taxpayer's private key controlling a specified quantity of coins or tokens is located. However, because private keys can be held in portable form (such as on a piece of paper or a USB stick), can be held in multiple places (either because a multi-signature key is used or because a taxpayer holds duplicates of its private keys in multiple locations) and/or can be memorized by the taxpayer, such a rule could lead to results that make little sense in practice. We therefore would generally recommend that the location of cryptocurrency to which a taxpayer holds the private keys directly should be that taxpayer's jurisdiction of residence for U.S. federal income tax purposes. However, where a taxpayer owns cryptocurrency in a manner in which it does not control the private keys associated with those coins or tokens, such as on an exchange, we believe that the coins or tokens should be considered located where the service provider controlling the relevant private keys is located.

Programmers, entrepreneurs, investors, traders and other market participants based in the United States hold coins and tokens on foreign exchanges or through non-U.S. wallet providers for many reasons. A number of non-U.S. jurisdictions have progressed further in terms of providing greater non-tax legal certainty to service providers, projects and investors than the United States.[90] For example, Japan and Korea have established robust regulatory frameworks for exchanges.[91] Other jurisdictions like Malta are updating their legislation to provide rules for new types of assets and arrangements, giving greater legal certainty to developers and service providers than legal systems that are trying to fit cryptocurrency and related arrangements into categories originally created for physical assets and centrally controlled entities.[92] Finally, projects

[90] There is currently a bill before Congress that would provide a broader framework for regulation of cryptocurrency. *See* Paul Gosar, *Crypto-Currency Act of 2020*, 116th Cong., Discussion Draft to be Referred to the Committee (2019).

[91] Stephen O'Neal, *South Korea Is Hoping for Regulatory Clarity as Crypto Laws Toughen*, COINTELEGRAPH, (Oct. 6, 2019), https://cointelegraph.com/news/south-korea-is-hoping-for-regulatory-clarity-as-crypto-laws-toughen; William Suberg, *Japan: Regulators Approve Start's Bitcoin Sidechain Trial for Exchanges*, COINTELEGRAPH, (Jan. 21, 2019), https://cointelegraph.com/news/japan-regulators-approve-startups-bitcoin-sidechain-trial-for-exchanges; Wirex Team, *Cryptocurrency in Japan: A Regulatory Overview*, WIREX, (Aug. 15, 2019), https://wirexapp.com/blog/post/cryptocurrency-in-japan-a-regulatory-overview-0159.

[92] *Virtual Financial Assets Act, 2018* (Act XXX) (Malta) https://parlament.mt/media/94209/bill-44-virtual-financial-assets-bill.pdf; *Malta Digital Innovation Authority Act, 2018* (Act XXXI) (Malta) https://parlament.mt/media/95199/act-xxxi-malta-digital-innovation-authority-act.pdf; *Innovative Technology*

developing the open source software underlying a new coin or token may establish non profit foundations in jurisdictions like Switzerland that provide clear frameworks of operation for such foundations. As a result, many coins and tokens created by newer projects are only available on non-U.S. exchanges or only supported by other network infrastructure outside the United States. Moreover, often non-U.S. exchanges have higher trading volumes and liquidity[93] in certain coins and tokens and therefore pricing may be less vulnerable to manipulation than on certain U.S. exchanges. "Anti-money laundering" and "know your customer" requirements are becoming widespread around the world and exchanges and service providers are implementing these rules, so anonymous third party services are increasingly unavailable, including outside the United States.[94]

While there are thus legitimate reasons for U.S. taxpayers to hold cryptocurrency through third parties located outside the United States, we are sympathetic to the Service's need to obtain information about transactions by U.S. taxpayers in international cryptocurrency markets and projects. This development is consistent with a push to obtain "anti-money laundering" and "know your customer" as well as tax information regarding cryptocurrency holders in a number of jurisdictions.[95] However, as this remains an evolving field with many uses beyond exchangeable virtual currency, we would suggest that Treasury and the Service consider how to balance the need for comprehensive and accurate information about the activities of U.S. taxpayers against the risk that access by U.S. participants to this developing field of technology may be limited as a result.

Arrangement and Services Act, 2018 (Act XXXIII) (Malta) http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lp&itemid=29078&l=1.

[93] For example, the Bilaxy exchange based in the Seychelles has some of the highest reported trading volumes based on CoinMarketCap. *About Bilaxy*, COINMARKETCAP, https://coinmarketcap.com/exchanges/bilaxy/ (last visited Dec. 20, 2019, 12:16 PM).

[94] Ana Alexandre, *Binance Integrates Coinfirm's AML Platform to Comply With FATF Rules*, COINTELEGRAPH, (Oct. 3, 2019), https://cointelegraph.com/news/binance-integrates-coinfirms-aml-platform-to-comply-with-fatf-rules; Kenneth A. Blanco, *Prepared Remarks of FinCEN Director Kenneth A. Blanco at Chainalysis Blockchain Symposium*, FINCEN, (Nov. 15, 2019), https://www.fincen.gov/news/speeches/prepared-remarks-fincen-director-kenneth-blanco-chainalysis-blockchain-symposium; Pedro Gonçalvez, *Cayman Tells Crypto Services to Comply with AML Rules*, INTERNATIONAL INVESTMENT, (Nov. 25, 2019), https://www.internationalinvestment.net/news/4007308/cayman-tells-crypto-services-comply-aml-rules; Graham Smith, *Coinbase Patents AI Compliance System to Monitor and Flag Accounts*, BITCOIN, (Nov. 29, 2019), https://news.bitcoin.com/coinbase-patents-ai-compliance-system-to-automatically-flag-accounts/; Arian Zmudzinski, *After BottlePay, Two More Crypto Firms Shut Down Due to Upcoming EU Rules*, COINTELEGRAPH, (Dec. 16, 2019), https://cointelegraph.com/news/after-bottlepay-two-more-crypto-firms-shut-down-due-to-upcoming-eu-rules.

[95] Tax authorities in countries such as Denmark and Norway have already begun to do so. Ana Alexandre, *Report: Denmark's Tax Agency Is Sending Tax Compliance Letters to Crypto Users*, COINTELEGRAPH, (Dec. 10, 2019), https://cointelegraph.com/news/report-denmarks-tax-agency-is-sending-tax-compliance-letters-to-crypto-users; Kevin Helms, *Norway Establishes New Rules for Crypto Service Providers*, BITCOIN, (Oct. 6, 2018), https://news.bitcoin.com/norway-crypto-service-providers/.

1. Form 8938

Section 6038D requires certain U.S. taxpayers to report holdings of "specified foreign financial assets" in excess of certain thresholds.[96] The question therefore arises whether accounts on foreign exchanges or wallets supported by a foreign wallet provider are "foreign accounts" maintained by a "foreign financial institution" within the meaning of Section 6038D(b)(1). While there are some domestic exchanges, most exchanges have been established abroad. As discussed above, many investors and traders hold their cryptocurrency through accounts on exchanges. Even more expert market participants that generally hold their private keys in private wallets outside of exchanges generally need to temporarily move cryptocurrency into accounts on exchanges in order to exchange or sell that cryptocurrency for another cryptoasset or a fiat currency. So exchanges and other types of intermediaries, many of them foreign, play a role in many (or most) transactions.

A "financial account" for purposes of Section 6038D includes a "custodial account" which in turn is defined as "an arrangement for holding a financial instrument, contract or investment."[97] Financial instruments, contracts or investments include but are not limited to stocks, debt obligations, currency or commodity transactions and swaps.[98] This definition appears to be sufficiently broad to include "virtual currency" within the meaning of the Guidance as a financial contract or investment. Given that exchanges are in the business of providing accounts through which their customers can invest and trade in cryptocurrency, holding private keys to coins and tokens that are credited to their customers' accounts and facilitating transactions by the account holders on the books and records of the exchange, it would seem that such exchanges hold "financial assets for the account of others as a substantial portion of their business,"[99] making them "custodial entities" for purposes of these rules.[100]

The case for treating a foreign wallet provider as a "foreign financial entity" appears to be less clear where all the wallet provider does is provide a software interface through which U.S. market participants can transact in a given coin or token from their computer or phone. We would note, however, that to the extent a wallet provider may hold or access a U.S. taxpayer's private keys such a "custodial" wallet provider should fall within the definition of a "custodial institution." We would recommend that the Service study the extent to which non-U.S. parties other than exchanges (including but not limited to certain types of wallet providers) might qualify as "custodial institutions" or otherwise fall within the ambit of these rules.[101]

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[96] If the aggregate of such assets exceeds $50,000 on the last day of the taxable year or $75,000 at any time during the taxable year, then certain taxpayers must report. *See* Section 6038D(a) and Treasury Regulation Section 1.6038D-2(a)(1).

[97] Section 6038D(b)(1); Section 1471(d)(2)(B); Treasury Regulation Section 1.1471-5(b)(3)(ii).

[98] Section 1471(d)(2)(B); Treasury Regulation Section 1.1471-5(b)(3)(ii).

[99] Section 1471(d)(5)(B); Treasury Regulation Section 1.1471-5(e)(3).

[100] An exchange's ability to transact for its own account using the private keys of its account holders is similar to a bank's ability to use funds deposited by its depositors. So the operations of an exchange may be akin to those of a depositary institution, but we do not believe exchanges otherwise satisfy the definition of "depositary institution". *See* Section 1471(d)(5)(A); Treasury Regulation Section 1.1471-5(e)(1)(i), (e)(2).

[101] While outside the realm of "foreign financial institutions," some platforms and technologies enable users to hold private keys and transact directly against an orderbook. Also, there is a large over-the-counter ("OTC") market

Based on the foregoing we believe there is a strong argument that virtual currency held in an account on a non-U.S. exchange is a "specified foreign financial asset" reportable on IRS Form 8938 if the value exceeds the specified U.S. dollar thresholds, and we recommend that the IRS so confirm. We do not recommend, however, that the Service apply the filing requirement retroactively and impose penalties for failure to file Form 8938 prior to the issuance of future guidance. Given that the Service has been studying cryptocurrencies for a number of years but has not previously advised taxpayers of the need to file IRS Form 8938 with respect to holdings of cryptocurrency, we recommend that the Service impose this requirement for future tax years only or, as an alternative, provide a penalty-free extension period for taxpayers to file forms for prior years.[102]

2. *FBAR*

In addition to providing guidance under Section 6038D, we encourage Treasury (through FinCEN) to provide guidance on whether reporting on FinCEN Form 114, Report of Foreign Bank and Financial Accounts ("FBAR") is required with respect to cryptocurrency held outside the United States. Until now, we understand that the informal position is that FBAR reporting is not currently required.[103] In order to maintain consistency with other "foreign" assets, we would recommend that, if Form 8938 is required with respect to holdings of cryptocurrencies on non-U.S. exchanges, guidance be issued applying FBAR reporting to virtual currencies held in accounts on non-U.S. exchanges for future reporting years.

Even if the FBAR filing requirement is not extended in this manner, we would suggest guidance be issued to alert U.S. persons that any foreign bank account linked to a cryptocurrency account on a foreign exchange[104] is itself reportable (provided the FBAR threshold is met). We are concerned that smaller market participants may not appreciate the distinction between a cryptocurrency account on an exchange and a linked bank account and may not have reported the bank account based on pronouncements by FinCEN officials that no reporting of cryptocurrency accounts was required.

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ecosystem. Mechanics vary, but essentially sales are arranged privately off chain and off-exchange, and then coins are moved peer to-peer usually after fiat currency funds have been deposited with a trusted escrow agent or OTC desk. The escrow agent could be anyone the buyer and seller trust, including an attorney or "broker". These transactions involve some kind of "middleman" but not necessarily a "financial institution" operating in the middle. We suggest that the Service study these kinds of arrangements, including when developing rules under Section 6045.

[102] In November of 2019, representatives of the Service recommended that taxpayers err on the side of filing IRS Form 8938 while acknowledging that the Service has not yet reached a definite position on whether such filing is required. They also expressed the view that the Service probably would not pursue penalties for failure to file IRS Form 8938 if taxpayers have reported taxable cryptocurrency transactions in prior years. Kristen A. Parillo, *IRS Explains Foreign Asset Reporting Rules for Cryptocurrency*, TAXNOTES, (Nov. 20, 2019), https://www.taxnotes.com/tax-notes-today-international/cryptocurrency/irs-explains-foreign-asset-reporting rules cryptocurrency/2019/11/20/2b4w4?highlight=foreign held%20cryptocurrency.

[103] Kristen A. Parillo, *Cryptocurrency Isn't Subject to FBAR Filing Rules*, TAXNOTES, (Nov. 14, 2019), https://www.taxnotes.com/tax-notes-today-federal/cryptocurrency/cryptocurrency-isnt-subject-fbar-filing-rules/2019/11/14/2b48g.

[104] We understand that accounts on some (but not all) non-U.S. cryptocurrency exchanges are linked to local bank accounts.

3. *FATCA Reporting*

Based on our analysis in Part V.B.1 above concluding that non-U.S. exchanges likely are "foreign financial institutions" in the category of "custodial institutions", these exchanges should also be subjected to the reporting regime applicable to "foreign financial institutions"[105] pursuant to Sections 1471 to 1474 (and the Treasury regulations promulgated thereunder) (commonly referred to as "FATCA"). We recommend that Treasury and the Service study how to apply FATCA compliance requirements to non-U.S. cryptocurrency exchanges. We note, in particular, that since these exchanges are much less likely than traditional financial institutions to receive material amounts of "withholdable payments,"[106] the threat of a 30% withholding tax is a much weaker incentive for compliance. The process of applying FATCA compliance to non-U.S. exchanges may require negotiations with partner jurisdictions around the world to clarify that cryptocurrency exchanges fall under applicable intergovernmental agreements relating to FATCA and may require legislative action from partner jurisdictions. While many exchanges are already complying with (or adapting their procedures to comply with) "anti-money laundering" and "know your customer" requirements more generally,[107] FATCA compliance may be more complex. Treasury and the Service may also wish to consider whether and how to tailor FATCA requirements for non-U.S. cryptocurrency exchanges, as they are generally smaller operations than most traditional non-U.S. financial institutions.

VI. OTHER AREAS WHERE GUIDANCE IS NEEDED

We believe there are numerous other areas in which further guidance from Treasury and the Service is needed.

A. Is Cryptocurrency a Commodity or a Security?

The Commodities Future Trading Commission (the "CFTC") views bitcoin and ether as commodities and the U.S. Securities and Exchange Commission (the "SEC") has treated many tokens and coins offered in "initial coin offerings" as securities. The SEC has also expressed views that bitcoin and ether are not securities.[108] The Service has historically deferred to the CFTC and its predecessor agencies as to what constitutes a "commodity" for U.S. federal income tax purposes,[109] leading some market participants to take the view that bitcoin and similar

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[105] Section 1471(b).

[106] Section 1473(1) (defining "withholdable payment"); Proposed Treasury Regulation Section 1.1473-1(a).

[107] Craig Adeyanju, *What Crypto Exchanges Do to Comply With KYC, AML and CFT Regulations*, COINTELEGRAPH (May 17, 2019), https://cointelegraph.com/news/what-crypto-exchanges-do-to-comply-with-kyc-aml-and-cft-regulations.

[108] *Chairman Tarbert Comments on Cryptocurrency Regulation at Yahoo! Finance All Markets Summit*, CFTC RELEASE No. 8051-19, (Oct. 10, 2019), https://www.cftc.gov/PressRoom/PressReleases/8051-19; Tim Fries, *Key Takeaways: The SEC Says Bitcoin Is Not A Security*, THE TOKENIST, (Oct. 7, 2019), https://thetokenist.io/key-takeaways-the-sec-says-bitcoin-is-not-a-security/; William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, U.S. SECURITIES AND EXCHANGE COMMISSION, (Jun. 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418; Louise Matsakis, *Rest Easy, Cryptocurrency Fans: Ether and Bitcoin Aren't Securities*, WIRED, (Jun. 14, 2018), https://www.wired.com/story/sec-ether-bitcoin-not-securities/.

[109] Rev. Rul. 73-158, 1973-1 C.B. 337.

cryptocurrencies are commodities for U.S. federal income tax purposes. Market participants would benefit greatly from certainty as to whether and when cryptocurrency is a commodity or security. Guidance in this area would answer questions relevant to persons dealing and trading in cryptocurrencies, including (1) the application of the mark-to-market rules of Section 475 to dealers and traders, (2) the availability of the securities and commodities trading safe harbors under Section 864(b) to non-U.S. investors (and funds with such investors), (3) the application of the wash sale rules under Section 1091, (4) the treatment of cryptocurrency for purposes of determining whether an entity is an "investment company" under Section 351(e) (and Section 721(b)), (5) the application of section 1256 to certain contracts involving cryptocurrency and (6) whether income from transactions involving cryptocurrencies constitutes "qualifying income" under Section 7704(d).

Guidance on the application of the straddle rules under Section 1092 would also be welcome. Given the broad scope of the definition of "personal property" under those rules and active trading in many cryptocurrencies, the straddle rules may already apply (irrespective of whether a cryptocurrency is a commodity or a security).[110] However, a clear pronouncement on the topic by Treasury and the Service would be helpful, especially now that the existence of cryptocurrency derivatives makes the creation of offsetting short and long positions in cryptocurrencies relatively easy.

We do not make any specific recommendation as to whether specified types of cryptocurrency should be classified as commodities or securities for U.S. federal income tax purposes but encourage Treasury and the Service to issue guidance on this important question.

B. Cryptocurrency Loans

Loans of cryptocurrency and loans denominated in cryptocurrency are an evolving field, and the tax treatment of such loans is unclear. Taxpayers borrow cryptocurrency to sell short or to cover short sales as well as to trade the borrowed coins or tokens for other cryptocurrencies. These transactions may resemble traditional securities lending transactions. We understand that taxpayers also lend coins and tokens through online platforms and earn an investment return colloquially referred to as "interest."[111] We recommend that Treasury and the Service study the different forms in which cryptocurrency is borrowed and lent and develop guidance on how such loans (or different versions thereof) are to be treated.

Given the volatility of cryptocurrencies as measured by fiat currencies, both the "principal" amount of such a loan and the amount denominated as "interest" are entirely contingent. The classic hallmark of a debt instrument, an unconditional promise to pay a sum certain,[112] thus seems

[110] Section 1092(d)(1).

[111] Some of these arrangements may resemble traditional deposit accounts in that an investor deposits cryptocurrency with a company and receives a return. *See* BlockFi.com. As well, emerging online platforms representing automated decentralized systems executing contracts through pre-set computer programs allow investors to deposit and lend cryptocurrency. *See Zero to DeFi – A Beginner's Guide to Earning Passive Income Via Compound Finance*, DEFI PULSE (Sept. 18, 2019), defipulse.com/blog/zero-to-defi-cdai/.

[112] *See, e.g.*, *Roth Steel Tube v. Commissioner*, 800 F.2d 625 (6th Cir. 1986); *Fin Hay Realty v. United States*, 398 F.2d 694 (9th Cir. 1984); Notice 94-47, 1994-1 C.B. 357.

to be absent. Moreover, given the potential fluctuation in value of "interest" amounts calculated in cryptocurrency (which, given volatility against fiat currencies, could go to zero), stated interest in practice is unlikely to reflect time value of money and does not resemble a conventional payment for the use or forbearance of money.[113] While these general features, in principle, could be said to be shared by foreign currency denominated debt instruments that are subject to currency fluctuations (though volatility there tends to be much lower), those instruments involve currency rather than property and are also governed by the specific rules of Section 988 and the Treasury regulations promulgated thereunder. In light of the foregoing features of cryptocurrency loans, debt characterization of cryptocurrency loans does not seem inevitable or even appropriate.

Guidance is needed to clarify how these loans should be treated for U.S. federal income tax purposes. Many cryptocurrency loans may be best analogized to securities loans that fall outside the scope of Section 1058,[114] but they may also bear resemblance to notional principal contracts with upfront payments,[115] or to leases.[116] Since the Section 988 rules are not applicable to loans of, or denominated in, cryptocurrencies,[117] the question also arises whether rules based on principles similar to Section 988 should apply under any such characterization. Guidance in this area is important, because it implicates whether the initial transfer and subsequent return of cryptocurrency are taxable transactions (and, if so, how gain or loss is determined) and because the characterization of income as interest or some other kind of ordinary income (*e.g.* securities lending fees) has many collateral effects on a U.S. taxpayer under the federal income tax laws as well as on the withholding tax consequences for payments to non-U.S. persons.

C. Coins and Tokens Beyond Virtual Currency Exchangeable for Cash

Guidance issued by the Service to-date has been limited to virtual currency that is convertible to fiat currency and functions as a substitute for cash, with bitcoin as the paradigm case. No guidance has been provided for tokens that function as "machine currency," that is, tokens that can be used to access certain services, or other uses, of a blockchain that does more than function as digital money. We recommend that Treasury and the Service study how best to craft tax rules appropriate for these emerging technologies.

D. Token Swaps

Guidance is needed in the treatment of so-called "token swaps." Swapping is the process of sending old (fundraising) tokens (received in a giveaway or acquired at the inception of a particular project) to an address controlled by the project developers. The original tokens are then

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[113] *See, e.g.*, *Old Colony R. Co. v. Commissioner*, 284 U.S. 552 (1932); Rev. Rul. 69-188, 1969-1 C.B. 54.

[114] Given the restrictive definition of "security" for purposes Section 1058, classifying certain coins and tokens as "securities" would not necessarily bring those coins and tokens within the scope of existing Section 1058. *See* Section 1058(a); Section 1236(e).

[115] Because cryptocurrency is transferred back and forth at inception and termination, such a loan should not qualify as a notional principal contract, but rules for the taxation of cryptocurrency loans could be developed by analogy to the rules for notional principal contracts. Treasury Regulation Section 1.446-3(c)(3).

[116] Lease characterization seems questionable since the borrower will not return the identical coins or tokens.

[117] Notice 2014-21, 2014-16 I.R.B. 938, Q2 (providing that cryptocurrency is not foreign currency).

destroyed or "burned" and exchanged in a one-to-one ratio for new tokens that are sent automatically to a new wallet address provided by the swapping holder. Exchanges often provide support for and handle this process for tokens held on their platform, though there is usually also a method by which persons who hold private keys outside an exchange can manually perform the swap. If a holder fails to swap its old tokens within a specified period of time, its old tokens will likely become worthless and it may forfeit its right to exchange them for new tokens after the expiration of the set period of time.

Prima facie, the exchange of an old token for a new token appears to be a taxable sale or exchange.[118] However, in context, the new tokens reflect a continuation of the original investment and in fact represent the asset (i.e. the "machine currency" that provides access to certain services or uses of the blockchain) the holder wanted to acquire at the outset of the project but that was not yet "ready" at that time. Receipt of the new token thus merely provides the asset the holder of the marketing token wanted to receive from the outset. We therefore believe that, for U.S. federal income tax purposes, such a token swap can be appropriately analogized to receipt of stock upon the exchange of a convertible debt instrument[119] or of an asset received upon physical settlement of a prepaid forward contract,[120] so that the holder of the original token would not have a taxable sale or exchange upon receipt of the new token. Alternatively, if viewed as a sale or exchange, we do not believe that the new token would "[differ] materially either in kind or extent" from the original marketing token" since the new token simply embodies the asset that was always the purpose of the original investment.[121] We recommend that Treasury and the Service issue guidance confirming this result in the context of fundraising tokens and providing that a holder who fails to take steps to exchange the old tokens and thus forfeits its right to receive the new token be entitled to a loss (insofar as the taxpayer had basis in the old token).[122]

E. Stable Coins

Stable coins are cryptocurrencies backed by holdings of fiat currency, whether the U.S. dollar or otherwise, or one or more financial assets that have a stable value or maintain a relatively stable value when issued through an automated decentralized system controlled by a pre-set

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[118] Section 1001.

[119] Rev. Rul. 72-265, 1972-1 C.B. 222 (no gain realized upon exchange of convertible debt instrument into stock of obligor corporation).

[120] Here the asset to be delivered does not exist at the time the forward is entered into. *See Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011) (defining forward contract as executory contract for delivery of property at future date); *Lucas v. North Texas Lumber Co.*, 281 U.S. 11 (1930) (executory contract not taxable event until settlement); CCA 201501012 (Jan. 2, 2015); Rev. Rul. 2003-7, 2003-5 I.R.B. 363 (prepaid forward contract does not result in current sale where certain conditions met). Upon settlement of a forward contract, the buyer takes basis in the asset.

[121] Treasury Regulation Section 1.1001-1(a). *See also* Rev. Rul. 90-7, 1990-1 C.B. 153 (exchanging trust certificates in investment trust for underlying assets not taxable sale or exchange).

[122] Where a token swap occurs outside the context of fundraising tokens being exchanged for tokens representing the originally intended asset, such as where a cryptocurrency migrates from one blockchain to another, we believe the swap should be analyzed under the general principles of Treasury Regulation Section 1.1001-1(a). If the token swap is merely part of a technical upgrade (for example, a migration to a new blockchain with certain enhanced features) the new token may not "differ materially in kind or extent."

computer program.[123] Because transactions involving stable coins backed by fiat currencies other than the U.S. dollar could be said to be "denominated in terms of a nonfunctional currency or [be] determined by reference to the value of one or more nonfunctional currencies,"[124] the question arises whether holdings of such stable coins and transactions in (or denominated in) such stable coins fall within the scope of Section 988. We urge Treasury and the Service to consider the potential interaction between Section 988 and the existing guidance on cryptocurrencies and to issue guidance addressing the taxation of stable coins backed by fiat currencies other than the U.S. dollar.

F. Private Coins

All guidance regarding cryptocurrency issued by the Service to-date has been focused on public open-source blockchains or distributed ledger systems. However, there is a separate and growing world of private blockchains or consortia of entities that create private currencies used for specific purposes. As these kinds of private coins become more prevalent, taxpayers will require guidance on whether the principles developed for public distributed ledger systems apply here as well. We urge Treasury and the Service to study this area, including but not limited to addressing whether existing guidance applies equally to private blockchains and related currencies that may be traded on secondary markets.[125]

G. Staking

To date many of the most established public blockchains rely on "proof of work" algorithms as a method for validating transactions and "mining" new blocks. While it was originally intended that "mining" would be a dispersed activity accessible to anyone with relatively standard computer equipment, "mining" of long established blockchains (like Bitcoin) now requires very significant hardware resources and large amounts of energy both to power the computers running the calculations and to cool the facilities housing the computers. Miners receive new coins as rewards for their efforts as well as transaction fees for confirming transactions. In reaction to the concentration of mining resources and the related energy consumption, there is now a movement towards "proof of stake" as an alternative consensus algorithm in parts of the cryptocurrency community.[126] Benefits of "proof of stake" include reduced costs and energy consumption, encouraging broader participation from members of the community to sustain a given blockchain and enhanced scalability.

"Proof of stake" requires computers (nodes) that wish to participate in the process of "forging" new blocks to lock up a portion of their coins or tokens as "stakes." Some staking activity is also tied to governance, giving stakers the right to vote on governance of a particular

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[123] An example of this includes Stasis EURS which is tied to the value of the euro. Elena Perez, *Fiat-Backed Stablecoins — Attempt to Take the Best of Both Worlds*, COINTELEGRAPH, (Oct. 6, 2019), https://cointelegraph.com/news/fiat-backed-stablecoins-attempt-to-take-the-best-of-both-worlds.

[124] Treasury Regulation Section 1.988-1(a)(1)(i).

[125] We note that the concept of a contentious hard fork should not be applicable in this context because the underlying code is privately developed and fully controlled by centralized parties.

[126] For example, Ethereum plans to switch from "proof of work" to "proof of stake" with Ethereum Casper likely in the course of 2020.

project (*e.g.* changes to the protocol or funding of future project development). Exchanges often participate in staking by using their customers' coins and may share staking rewards with their customers. Investors holding private keys outside of exchanges may be able to participate in staking via an interface provided by a wallet. Alternatively, they would need to take other direct steps to be able to stake (requiring greater technical expertise). Generally, the bigger the stake, the higher the likelihood that a node will be selected to forge the next block, though randomization features are built in to reduce domination by the "wealthiest" nodes. "Coin age," which measures how long coins have been staked, can be another relevant factor in selecting a node that will be selected to forge.

When a node is selected to forge a new block, it validates the transactions and receives transaction fees with respect to transactions in that block. Staking networks also typically provide an annual return (ranging from 0.5% to 15%) for all stakers (commonly referred to as "inflation payments") to encourage more participants to lock up some of their coins and support the network. Some networks require the operation of so-called "Master Nodes," which must pledge a specified minimum number of coins in order for the holder to receive a set distribution of additional coins from the network. Payments in staking networks tend to be smaller but more predictable than mining rewards in "proof of work" networks. Payments can be made at frequent intervals (even multiple times a day).[127]

Notice 2014-21 provided that mining rewards constitute gross income.[128] We believe that payments received as transaction fees for forging new blocks in a "proof of stake" network should similarly be treated as giving rise to gross income. However, the correct tax treatment of inflation payments made to all stakers in a "proof of stake" network is less clear. The issuance of additional coins or tokens could be treated as a return on a staker's investment that constitutes an accession to wealth. On the other hand, given that increasing the coin supply may dilute the value of existing coins and that staking participation may be very high in certain "proof of stake" networks, inflation payments also could be viewed as analogous to stock dividends and thus not be taxable currently.[129] We recommend that Treasury and the Service further study inflation payments. As discussed in Part III.B.2 above, valuation can be difficult, especially with the newer, less established coins and tokens that may be received in many "proof of stake" networks.

H. Virtual Currency Not Held As a Capital Asset

Except to the limited extent set forth therein, the FAQs as well as Notice 2014-21 only address taxpayers that hold cryptocurrency as capital assets.[130] Guidance is needed for persons

[127] Harsh Agrawal, *10 Most Profitable Proof Of Stake (POS) Cryptocurrencies*, COINSUTRA, (Dec. 4, 2019), https://coinsutra.com/proof-of-stake-cryptocurrencies/.

[128] Notice 2014-21, 2014-16 I.R.B. 938, Q8.

[129] *Eisner v. Macomber*, 252 U.S. 189 (1920). Unlike pro rata stock dividends, however, there is no guarantee that inflation payments will be made to all holders on a pro rata basis since not all coin or token holders may participate in staking and different holders may stake different proportions of their holdings.

[130] *See Frequently Asked Questions on Virtual Currency Transactions*, IRS https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated Dec. 31, 2019) (including statement that "except as otherwise noted, these FAQs apply only to taxpayers who hold virtual currency as a capital asset").

that hold and use cryptocurrency in inventory (e.g. as dealers) or otherwise in connection with a trade or business (rather than as an investment asset), including in connection with service or utility tokens and other emerging technological applications.

(b)(5) Deliberative Process Privilege

116TH CONGRESS
2D SESSION

H. R. 5635

To amend the Internal Revenue Code of 1986 to exclude from gross income gain from disposition of virtual currency in a personal transaction.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 16, 2020

Ms. DELBENE (for herself, Mr. SCHWEIKERT, Mr. SOTO, and Mr. EMMER) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to exclude from gross income gain from disposition of virtual currency in a personal transaction.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Virtual Currency Tax Fairness Act of 2020".

SEC. 2. VIRTUAL CURRENCY.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1986 is amended by inserting after section 139F the following new section:

"SEC. 139G. GAIN FROM DISPOSITION OF VIRTUAL CURRENCY.

"(a) IN GENERAL.—Gross income of an individual shall not include gain, by reason of changes in exchange rates, from the disposition of virtual currency in a personal transaction (as such term is defined in section 988(e)). The preceding sentence shall not apply if the gain which would otherwise be recognized on the transaction exceeds $200.

"(b) VIRTUAL CURRENCY.—For purposes of this section, the term 'virtual currency' means a digital representation of value that is used as a medium of exchange and is not otherwise currency under section 988.".

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 of such Code is amended by inserting after the item relating to section 139F the following new item:

"Sec. 139G. Gain from disposition of virtual currency.".

(c) REPORTING OF GAINS OR LOSSES.—The Secretary shall issue regulations providing for information returns on virtual currency transactions for which gain or loss is recognized.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to transactions entered into after December 31, 2019.

○

Virtual Currency Tax Fairness Act

Congresswoman Suzan DelBene (WA-01) and Congressman David Schweikert (AZ-06), have introduced legislation regarding the tax treatment of virtual currencies, *the Virtual Currency Tax Fairness Act*. Instead of going against current IRS guidance, this legislation amends the Internal Revenue Code of 1986 by inserting a new section, Sec. 139G, which provides a de minimis exemption for personal transactions made with virtual currency whose gains are less than or equal to $200 and directs the Secretary of the Treasury to issue regulations for reporting personal transactions using virtual currency whose gains exceed $200.

Under current U.S. law, any gain realized due to changes in exchange rates from a transaction using virtual currency must be reported as taxable income regardless of the purpose or size of the transaction. In practice, this means that each time someone buys a cup of coffee using virtual currency, they are legally obligated to calculate the amount that the virtual currency they used appreciated or depreciated against the U.S. dollar from the time they purchased the virtual currency to the time they bought the coffee, then report any gains to the IRS. This process makes the use of virtual currency in personal transactions untenable and inhibits the growth of the U.S. digital economy.

This legislation applies laws already on the books and would bring parity to an emerging sector in order to encourage the use of virtual currencies without complicating the tax code.

The legislation text is included below. To become a cosponsor, contact Victoria Honard (DelBene), Victoria.Honard@mail.house.gov or Tiffany Angulo (Schweikert), Tiffany.Angulo@mail.house.gov

Paul William M

From: Goldstein Ronald J
Sent: Thursday, February 27, 2020 2:48 PM
To: Paul William M
Cc: Moriarty John P; Hanlon-Bolton Julie; Wrobel Christopher; Yu James; Giuliano Amy F
Subject: VC Legislative Proposal
Attachments: BILLS-116hr5635ih.pdf; Virtual Currency Legislation_One Pager_FINAL[1].pdf

Good afternoon Bill. Legislative Affairs has forwarded to IT&A a request from Senator Cotton's office for comments on the Virtual Currency Tax Fairness Act, H.R. 5635 (attached), which proposes to amend the Internal Revenue Code to insert a *de minimis* exception excluding from gross income gains of $200 or less arising from the disposition of virtual currency in a personal transaction.

We have coordinated with ACCI, P&A, SBSE Division Counsel, and LB&I. Below are the combined comments regarding the language of the proposed legislation. Please let us know if you have any comments or would like to discuss. Thanks.

(b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

Ron Goldstein
STR - CC:ITA:B4
202.317.4887

Paul William M

From: Friedland Bruce I
Sent: Friday, February 14, 2020 11:23 AM
To: Flax Nikole C; Desmond Michael J; Cullinan Thomas A; Cardone John V; O'Donnell Douglas W; Paul William M
Cc: Lemons Terry L; Eldridge Michelle L; Reynolds Jodie M
Subject: UPDATED STATEMENT: Virtual Currency

(b)(5) Deliberative Process Privilege

[redacted]

From: Flax Nikole C [redacted] (b)(6)
Date: Friday, Feb 14, 2020, 8:47 AM
To: Desmond Michael J <[redacted] (b)(6) Friedland Bruce I <[redacted] (b)(6)
Cc: Cullinan Thomas A <[redacted] (b)(6), Cardone John V <[redacted] (b)(6), O'Donnell Douglas W <[redacted] (b)(6) Paul William M <[redacted] (b)(6)
Subject: RE: Virtual Currency

Bruce – we need to amend the language a bit. Will resend.

From: Desmond Michael J <[redacted] (b)(6)
Sent: Friday, February 14, 2020 8:46 AM
To: Flax Nikole C <[redacted] (b)(6)
Cc: Cullinan Thomas A <[redacted] (b)(6); Cardone John V <[redacted] (b)(6)
O'Donnell Douglas W <[redacted] (b)(6); Paul William M <[redacted] (b)(6)
Subject: RE: Virtual Currency

Nikoke,

Wrobel Christopher

From:	Friedland Bruce I
Sent:	Thursday, February 13, 2020 1:26 PM
To:	Wrobel Christopher; Goldstein Ronald J
Subject:	ARTICLE: CNN - IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns

IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns

CNN

Washington, DC (CNN Business) For months leading up to this tax season, a section of the IRS's website advised players of Fortnite, the popular online video game, that their use of in-game virtual currency could be subject to federal taxes.

The little-noticed provision, which dated back at least to October according to the cached version of an IRS webpage on Archive.org, appeared to mark the first time the agency has ruled on video game currencies, including Fortnite's V-bucks, purchased with real dollars. By applying the same policy to in-game money that it enforces on bitcoin, ether and other cryptocurrencies, the IRS guide seemed poised to affect millions of gamers — or their parents.

But on Wednesday, the IRS scrubbed all mentions of the in-game currency from the webpage after questions from CNN and other outlets about the policy. Despite the sudden deletion, experts believe that transactions involving video game currencies will still need to be reported under a new question the IRS is including this year on tax forms. Just because the IRS deleted the language, they said, does not resolve questions about how the IRS plans to treat video game currencies.

The IRS didn't respond to multiple requests for comment, and did not respond when CNN asked for a clear statement about the tax treatment of video game currencies.

The IRS's unexplained changes only add to confusion about how it is handling tax filings for virtual currencies -- and which digital products are lumped into the category. "[The] definition of virtual currency in IRS guidance would still encompass these," Jerry Brito, executive director at the Coin Center, a virtual currency think tank, wrote on Twitter after the changes. "I don't think they realized the consequences of their 1040 question."

The agency has long reminded Americans that virtual currency is treated like property for tax purposes. When Americans buy bitcoin, for example, they need to keep track of how much they paid for it. When they sell, they need to report any appreciation in value and pay taxes on those capital gains (and can claim a loss if there were realized losses). Using bitcoin to buy goods and services, even a coffee, is still considered a sale of property and potentially a taxable event. The IRS published a landmark policy guidance in 2014 laying out the details, and another update last year.

Last fall, the IRS appeared to clarify that the same tax policy also applies to video game currencies. "Bitcoin, Ether, Roblox, and V-bucks are a few examples of a convertible virtual currency," the IRS said on the webpage, prior to removing the language on Wednesday. The IRS did not appear to limit the types of video game currencies that may be covered under the policy.

Modern video games have increasingly turned to sales of virtual currency — which can then be used to purchase in-game costumes, weapon skins and randomized loot boxes — as a form of revenue.

Popular online games such as Apex Legends, PlayerUnknown's Battlegrounds and League of Legends all use in-game currencies and are likely subject to the rule, said Neeraj Agrawal, a spokesman for the Coin Center.

"Every major online game has some kind of in-game economy at this point," he said. "It's a very popular mechanic."

Fortnite in particular has become an internet sensation, amassing $1.8 billion in revenue last year, according to industry estimates. Last March, Fortnite's publisher, Epic Games, announced the title had nearly 250 million registered players around the globe.

Following the IRS's surgical edits this week, bitcoin is the only remaining example of a virtual currency offered on the agency webpage. But just because V-bucks have been removed does not mean the IRS regards all transactions in the currency as tax-exempt.

"They probably removed it because it's not particularly accurate, or had some error," said Mark Steber, chief tax officer at the tax prep company Jackson Hewitt. "In the law, if it's not specifically exempted, then it's taxable. Nothing is exempt from taxation which is not excluded from the law."

Taxpayers who had virtual currency transactions in 2019 will need to fill out Schedule 1 with their Form 1040, according to the IRS's 1040 instructions. The first question on Schedule 1: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

According to the instructions for Schedule 1, taxpayers will need to answer yes if they have engaged in a transaction involving virtual currency; if they have received any amount of virtual currency for free; have exchanged virtual currency for goods or services; have sold virtual currency; or have exchanged virtual currency for other property, including other virtual currency.

The reversal came the same day that the Government Accountability Office published a report calling on the IRS to provide "clarified guidance" on virtual currencies.

Some tax experts said the agency is simply struggling to apply time-honored tax principles to novel technologies.

"The IRS is trying to communicate that an accretion of value ... will trigger a taxable event, whether you are using the currency to buy a tangible item or to acquire a virtual item," said Mary Baker, who leads the tax policy practice at the law firm K&L Gates in Washington. "How to keep track of these transactions and their taxable effect is an issue that Congress and the Treasury Department both are grappling with."

Just because you may need to answer "yes" to the question on Schedule 1 does not necessarily mean you need to fill out anything else, Steber said. It depends on your personal situation. But some may need to report capital gains stemming from their virtual currency transactions on other forms.

"This question is an indicator that more is likely coming — more guidance, more rules, more requirements, more oversight and monitoring by the IRS," he said. "It's no longer something that's going to live in the background shadows. There's too much money there."

Instructions for Schedule 1
Additional Income and Adjustments To Income

General Instructions

Use Schedule 1 to report income or adjustments to income that can't be entered directly on Form 1040 or 1040-SR.

Additional income is entered on Schedule 1, lines 1 through 8. The amount on line 9 of Schedule 1 is entered on Form 1040 or 1040-SR, line 7a.

Adjustments to income are entered on Schedule 1, lines 10 through 22. The amount on line 22 is entered on Form 1040 or 1040-SR, line 8a.

(b)(5) Deliberative Process Privilege

Virtual Currency

f, in 2019, you engaged in any transaction involving virtual currency, check he "Yes" box next to the question on irtual currency at the top of Schedule 1. A transaction involving virtual currency ncludes:

- The receipt or transfer of virtual urrency for free (without providing any onsideration), including from an airdrop or following a hard fork;
- An exchange of virtual currency or goods or services;
- A sale of virtual currency; and
- An exchange of virtual currency or other property, including for another irtual currency.

If you disposed of any virtual curreny that was held as a capital asset, use Form 8949 to figure your capital gain or oss and report it on Schedule D (Form 040 or 1040-SR).

If you received any virtual currency s compensation for services or disposed f any virtual currency that you held for ale to customers in a trade or business, ou must report the income as you vould report other income of the same ype (for example, W-2 wages on Form 040 or 1040-SR, line 1, or inventory or ervices from Schedule C on Schedule).

If, in 2019, you have not engaged in any transaction involving virtual currency, and you don't otherwise have to file Schedule 1, you don't have to do anything further. If you otherwise have to file Schedule 1, check the "No" box.

For more information, go to *IRS.gov/virtualcurrencyfaqs*.

Additional Income

Line 1

Taxable Refunds, Credits, or Offsets of State and Local Income Taxes

TIP *None of your refund is taxable if, in the year you paid the tax, you either (a) didn't itemize deductions, or (b) elected to deduct state and local general sales taxes instead of state and local income taxes.*

If you received a refund, credit, or offset of state or local income taxes in 2019, you may be required to report this amount. If you didn't receive a Form 1099-G, check with the government agency that made the payments to you. Your 2019 Form 1099-G may have been made available to you only in an electronic format, and you will need to get instructions from the agency to retrieve this document. Report any taxable refund you received even if you didn't receive Form 1099-G.

If you chose to apply part or all of the refund to your 2019 estimated state or local income tax, the amount applied is treated as received in 2019. If the refund was for a tax you paid in 2018 and you deducted state and local income taxes on your 2018 Schedule A, use the State and Local Income Tax Refund Worksheet in these instructions to see if any of your refund is taxable.

Exception. See *Itemized Deduction Recoveries* in Pub. 525 instead of using the State and Local Income Tax Refund Worksheet in these instructions if any of the following applies.

1. You received a refund in 2019 that is for a tax year other than 2018.
2. You received a refund other than an income tax refund, such as a general sales tax or real property tax refund, in 2019 of an amount deducted or credit claimed in an earlier year.
3. You had taxable income on your 2018 Form 1040, line 10, but no tax on your Form 1040, line 11, because of the 0% tax rate on net capital gain and qualified dividends in certain situations.
4. Your 2018 state and local income tax refund is more than your 2018 state and local income tax deduction minus the amount you could have deducted as your 2018 state and local general sales taxes.
5. You made your last payment of 2018 estimated state or local income tax in 2019.
6. You owed alternative minimum tax in 2018.
7. You couldn't use the full amount of credits you were entitled to in 2018 because the total credits were more than the amount shown on your 2018 Form 1040, line 11.
8. You could be claimed as a dependent by someone else in 2018.
9. You received a refund because of a jointly filed state or local income tax return, but you aren't filing a joint 2019 Form 1040 with the same person.

Lines 2a and 2b

Alimony Received

Line 2a

Enter amounts received as alimony or separate maintenance pursuant to a divorce or separation agreement entered into on or before December 31, 2018, unless that agreement was changed after December 31, 2018 to expressly provide that alimony received isn't included in your income. Alimony received is not included in your income if you entered into a divorce or separation agreement

IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns

By Brian Fung, CNN Business

Updated 4:21 PM ET, Thu February 13, 2020

Washington, DC (CNN Business) — For months leading up to this tax season, a section of the IRS's website advised players of Fortnite, the popular online video game, that their use of in-game virtual currency could be subject to federal taxes.

The little-noticed provision, which dated back at least to October according to the cached version of an IRS webpage on Archive.org, appeared to mark the first time the agency has ruled on video game currencies, including Fortnite's V-bucks, purchased with real dollars. By applying the same policy to in-game money that it enforces on bitcoin, ether and other cryptocurrencies, the IRS guide seemed poised to affect millions of gamers — or their parents.

But on Wednesday, the IRS scrubbed all mentions of the in-game currency from the webpage after questions from CNN and other outlets about the policy. Despite the sudden deletion, experts believe that transactions involving video game currencies will still need to be reported under a new question the IRS is including this year on tax forms. Just because the IRS deleted the language, they said, does not resolve questions about how the IRS plans to treat video game currencies.

The day after the agency deleted the guideline, IRS Chief Counsel Michael Desmond told reporters at a Washington conference that including the video game currencies had been a mistake, the agency confirmed to CNN on Thursday. Desmond's remarks were first reported by Bloomberg.

"It was corrected and that was done quickly — as soon as it was brought to our attention," Desmond said, according to Bloomberg's report. However, the IRS did not respond when CNN asked for a statement clarifying the tax treatment of video game currencies.

The IRS's changes only add to confusion about how it is handling tax filings for virtual currencies -- and which digital products are lumped into the category. "[The] definition of virtual currency in IRS guidance would still encompass these," Jerry Brito, executive director at the Coin Center, a virtual currency think tank, wrote on Twitter after the changes on Wednesday. "I don't think they realized the consequences of their 1040 question."

The agency has long reminded Americans that virtual currency is treated like property for tax purposes. When Americans buy bitcoin, for example, they need to keep track of how much they paid for it. When they sell, they need to report any appreciation in value and pay taxes on those capital gains (and can claim a loss if there were realized losses). Using bitcoin to buy goods and services, even a coffee, is still considered a sale of property and potentially a taxable event. The IRS published a landmark policy guidance in 2014 laying out the details, and another update last year.

Last fall, the IRS appeared to clarify that the same tax policy also applies to video game currencies.

"[illegible], Ether, [illegible] and V-bucks are a few examples of a convertible virtual currency," the IRS said [illegible] removing the language on Wednesday. The IRS did not appear to limit the types of video game currencies that may be covered under the policy.

Modern video games have increasingly turned to sales of virtual currency — which can then be used to purchase in-game costumes, weapon skins and randomized loot boxes — as a form of revenue.

Popular online games such as Apex Legends, PlayerUnknown's Battlegrounds and League of Legends all use in-game currencies and are likely subject to the rule, said Neeraj Agrawal, a spokesman for the Coin Center.

"Every major online game has some kind of in-game economy at this point," he said. "It's a very popular mechanic."

Fortnite in particular has become an internet sensation, amassing $1.8 billion in revenue last year, according to industry estimates. Last March, Fortnite's publisher, Epic Games, announced the title had nearly 250 million registered players around the globe.

Following the IRS's surgical edits this week, bitcoin is the only remaining example of a virtual currency offered on the agency webpage. But just because V-bucks have been removed does not mean the IRS regards all transactions in the currency as tax-exempt.

"They probably removed it because it's not particularly accurate, or had some error," said Mark Steber, chief tax officer at the tax prep company Jackson Hewitt. "In the law, if it's not specifically exempted, then it's taxable. Nothing is exempt from taxation which is not excluded from the law."

Taxpayers who had virtual currency transactions in 2019 will need to fill out Schedule 1 with their Form 1040, according to the IRS's 1040 instructions. The first question on Schedule 1: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

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The reversal came the same day that the Government Accountability Office published a report calling on the IRS to provide "clarified guidance" on virtual currencies.

Some tax experts said the agency is simply struggling to apply time-honored tax principles to novel technologies.

"The IRS is trying to communicate that an accretion of value . . will trigger a taxable event, whether you are using the currency to buy a tangible item or to acquire a virtual item," said Mary Baker, who leads the tax policy practice at the law firm K&L Gates in Washington. "How to keep track of these transactions and their taxable effect is an issue that Congress and the Treasury Department both are grappling with."

Just because you may need to answer "yes" to the question on Schedule 1 does not necessarily mean you need to fill out anything else, Steber said. It depends on your personal situation. But some may need to report capital gains stemming from their virtual currency transactions on other forms.

"[illegible] indicator that more is likely coming — more guidance, more rules, more r[illegible] sight and monitoring by the IRS," he said. "It's no longer something that's going to live in the background shadows. There's too much money there."

Although there's much that's still unsettled about how to track virtual currency transactions — and who should be responsible for it — Baker said the onus is still on taxpayers to figure out whether they owe the IRS and to fill out an accurate tax return, at least for now.

Prepared for: IPAUTH USER

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Calling Fortnite Cash a Virtual Currency Was an IRS Error

By Allyson Versprille

Feb. 13, 2020, 2:26 PM

- Many video games have their own currencies used to purchase in-game upgrades
- IRS form asks taxpayers if they have acquired, sold virtual currency

Bloomberg Law News 2020-02-14T08:01:44097-05:00

Calling Fortnite Cash a Virtual Currency Was an IRS Error

By Allyson Versprille 2020-02-13T14:26:11000-05:00

Many video games have their own currencies used to purchase in-game upgrades

IRS form asks taxpayers if they have acquired, sold virtual currency

The IRS quickly recognized the need to correct website language that appeared to signal Fortnite and Roblox players were subject to a new disclosure requirement [illegible] virtual currency transactions, the agency's top lawyer said.

The agency on Wednesday removed language identifying Robux and V-bucks—Fortnite's in-game currency—as examples of convertible virtual currency. The language was removed hours after Bloomberg Tax asked if gamers who purchased or earned in-game currencies would have to disclose that on their 2019 tax [illegible].

IRS Chief Counsel Michael Desmond indicated that the inclusion of the video game currencies was a mistake, though he offered no insight on how they ended up alongside Bitcoin on the list of examples.

"It was corrected and that was done quickly—as soon as it was brought to our attention," Desmond told reporters Thursday at a Tax [illegible] Policy [illegible] conference in Washington.

The IRS has been focused on curbing cryptocurrency tax evasion. Last fall the agency released an updated Form 1040, which is used to report income, that for the first time asked taxpayers if they had received, sold, exchanged, or otherwise acquired a financial interest in a virtual currency.

Fortnite and Roblox, like many other online video games, allow players to earn or purchase in-game currencies that are used to customize and upgrade their characters.

[illegible], executive director of the advocacy group Coin Center, said Wednesday that labeling in-game currencies as convertible virtual currency could unknowingly subject millions of people to new IRS reporting requirements based on the agency's website. Even though the IRS pulled the language from the website, [illegible] said he is unsure whether that means people with in-game currency are in the clear.

Desmond demurred when asked to confirm that gamers wouldn't need to mark 'yes' to the new 1040 question, but said addressing gaming currencies in the virtual currency context isn't a major focus for the agency right now.

"[illegible] looking at that [illegible] not saying one way or another. I think I'll be getting ahead of myself [illegible] anything," Desmond said. [illegible] posted a correction yesterday and [illegible] leave it at that."

To contact the reporter on this story: Allyson Versprille in Washington at aversprille@bloombergtax.com

To contact the editors responsible for this story: Patrick Ambrosio at pambrosio@bloombergtax.com; Colleen Murphy at cmurphy@bloomberglaw.com

Related Articles

[illegible] Feb. 12, 2020, 6:34 PM

[illegible] Oct. 11, 2019, 12:10 PM

Paul William M

From: Desmond Michael J
Sent: Thursday, February 13, 2020 2:31 PM
To: Friedland Bruce I; Cullinan Thomas A; Paul William M
Cc: Lemons Terry L; Eldridge Michelle L; Reynolds Jodie M; Moriarty John P; Flax Nikole C
Subject: RE: MEDIA INQUIRY: Virtual Currency and Video Game "dollars"

FYI, at the TCPI conference today a number of trade reporters peppered me with questions on this. My response was limited - we were informed of the issue and quickly changed the web site, don't read too much into it. Lots of questions about whether we're doing guidance, etc.

Mike

From: Friedland Bruce I <[redacted] (b)(6)
Date: Wednesday, Feb 12, 2020, 4:56 PM
To: Cullinan Thomas A <[redacted] (b)(6), Desmond Michael J <[redacted] (b)(6), Paul William M <[redacted] (b)(6)
Cc: Lemons Terry L <[redacted] (b)(6), Eldridge Michelle L <[redacted] (b)(6), Reynolds Jodie M <[redacted] (b)(6) Moriarty John P <[redacted] (b)(6)
Subject: MEDIA INQUIRY: Virtual Currency and Video Game "dollars"

[redacted] (b)(5) Deliberative Process Privilege

Bruce

[redacted] (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

[redacted]

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in the U.S. Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain, DAG, or Tempo.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin, Ether, Roblox, and V-bucks are a few examples of a convertible virtual currency. Virtual currencies can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies

Paul William M

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 6:07 PM
To: Paul William M
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject: RE: Virtual Currency

Bill,

(b)(5) Deliberative Process Privilege

Thanks.

Chris

From: Paul William M
Sent: Thursday, February 13, 2020 5:46 PM
To: Wrobel Christopher <(b)(6)
Cc: Hanlon-Bolton Julie <(b)(6) Goldstein Ronald J <(b)(6); Kribell Wendy L <(b)(6); Moriarty John P <(b)(6)
Subject: RE: Virtual Currency

(b)(5) Deliberative Process Privilege

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 5:30 PM
To: Paul William M
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject: Virtual Currency

Bill,

Following is the language we drafted regarding the virtual currency gaming issue that we discussed this afternoon. John Cardonne has approved this language. Please let us know if you have any edits, and we will send it to Media Affairs. Thanks.

(b)(5) Deliberative Process Privilege

[redacted]

Chris

By Andrey Shevchenko 23 HOURS AGO

IRS Does Not Consider Fortnite Money as Virtual Currency After All

The Internal Revenue Service (IRS) removed wording on its website that put game currencies as examples of a convertible virtual currency. This clarification is important as a new tax filing requirement obliges taxpayers to report whether they dealt with virtual currencies.

The move was first reported (https://news.bloombergtax.com/daily-tax-report/irs-pulls-wording-subjecting-gamers-to-virtual-currency-question?context=search&index=0) by Bloomberg Tax on Feb. 13. Official guidelines on the IRS website (https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies) indicated Fortnite's V-bucks and Roblox's Robux as examples of virtual currencies. A screenshot captured by Bloomberg Tax shows a fairly detailed explanation of the concept, even mentioning blockchain alternatives such as the Directed Acyclic Graph (DAG).

What is Virtual Currency?

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in the U.S. Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain, DAG, or Tempo.

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Source: Bloomberg Tax (https://news.bloombergtax.com/daily-tax-report/irs-pulls-wording-subjecting-gamers-to-virtual-currency-question?context=search&index=0)

Ethereum

271

+1.05%

(https://cointelegraph.com/ethereum-price-index)

Poor examples of a virtual currency

The IRS definition of a virtual currency hinges on its ability to "operate like 'real' currency," which means that it needs to be freely transferable between users and easy to exchange for fiat currency.

Spokesmen from Epic Games, Fortnite's publisher, told Bloomberg that none of these apply to the game's currency:

> *"V-Bucks cannot 'be digitally traded between users,' nor can they be 'exchanged into, U.S. dollars, Euros, and other real or virtual currencies.'"*

Litecoin

81.70

+1.47%

(https://cointelegraph.com/ltc-price-index)

Roblox representatives voiced a similar stance, noting however that Robucks can be exchanged for fiat money under specific circumstances. The transaction is automatically submitted to the IRS, the company added.

The revised guidelines only mention Bitcoin (BTC (https://cointelegraph.com/bitcoin-price-index)), striking off a previously existing reference to Ether (ETH (https://cointelegraph.com/ethereum-price-index)) — which should fall under the definition.

Ripple

0.3296

+1.54%

Aggressive stance on crypto

The U.S. tax enforcement agency has recently made a strong move in its efforts to curb perceived tax evasion facilitated by crypto. Form 1040 now features (https://cointelegraph.com/news/us-irs-makes-change-to-standard-questions-in-regards-to-cryptocurrencies) a straightforward question:

> *"At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"*

(https://cointelegraph.com/xrp-price-index)

Categorizing game money as a virtual currency would have led to millions of people having to answer "yes" to this question. There are generally few profits to be made from owning game currencies, however.

EOS

5.3320

+0.72%

Given that lying on the form can cost (https://www.credit.com/blog/2019/11/lying-on-taxes-166824/) up to $250,000 in fines, this measure was likely introduced to force cryptocurrency users to go through the effort of reporting their gains.

(https://cointelegraph.com/eos-price-index)

Doing so is likely to be quite complicated. For example, each crypto-to-crypto exchange is considered as a taxable event that has to be reported. Though some hoped that these fall under the definition of a "like-kind exchange," an IRS official denied (https://cointelegraph.com/news/irs-like-kind-tax-exemption-has-never-applied-to-crypto-transactions) this. This definition would have meant that cryptocurrency gains are only taxed when converting to fiat currency.

Cryptocurrency taxation remains (https://cointelegraph.com/news/around-the-world-in-2019-a-landmark-year-for-crypto-taxation) an unclear subject, with worldwide regulators having widely diverging approaches. As an example, France does not tax crypto-to-crypto transactions.

A new bill recently proposed (https://cointelegraph.com/news/bill-to-exempt-small-crypto-transactions-from-taxes-returns-to-us-congress) in the U.S. Congress could ease the use of crypto for payments by exempting low value transactions from tax returns.

#IRS (/tags/irs) #Taxes (/tags/taxes)

#Ethereum News (/tags/ethereum) #Games (/tags/games)

#Regulation News (/tags/regulation)

Disappearing Forks and Magical Airdrops

POSTED ON NOV. 20, 2019

By

DAVID G. CHAMBERLAIN

RODNEY P. MOCK

KATHRYN KISSKA-SCHULZE

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David G. Chamberlain is an assistant professor of accounting, and Rodney P. Mock is the graduate tax program director and a professor of accounting, at California Polytechnic State University. Kathryn Kisska-Schulze is an assistant professor in the School of Accountancy at Clemson University.

In this article, the authors argue that the IRS misguides taxpayers because it confuses cryptocurrency hard forks and airdrops in newly issued Rev. Rul. 2019-24.

Introduction

On August 1, 2017, bitcoin cash (BCH)[1] entered the cryptocurrency scene because of a hard fork in the bitcoin blockchain.[2] The hard fork was the product of a dispute within the bitcoin community over whether to modify the software protocol underlying the cryptocurrency to increase the block size and improve scalability.[3] The blockchain forked, and every bitcoin investor became the owner of one coin of BCH for each bitcoin owned.[4] BCH opened at $294.60, reached a high of $426.11, and closed at $380.01 — the initial market capitalization for BCH was about $6.3 billion.[5]

Thus, the stakes are high for correct tax treatment of the BCH fork. If the entire $6.3 billion is treated as income and taxed at the highest individual income tax rate, nearly $2.5

billion in potential Treasury revenue is at stake.[6] The statute of limitations remains open for those who misreported their income and penalties could apply.[7]

On October 9, the IRS released Rev. Rul. 2019-24, 2019-44 IRB 1004, which purports to address the tax treatment of hard forks.[8] The ruling indicates that taxpayers who own a cryptocurrency that experiences a hard fork can be taxed on the full fair market value of the new cryptocurrency that emerges from the fork.[9] The IRS construes the new cryptocurrency as "free money" — similar to prizes or treasure trove. The receipt of a new cryptocurrency in a hard fork, however, as this article illustrates, is by no means equivalent to receiving free stuff.

Receiving anything for nothing in this world is rare, except perhaps when it comes from Grandma. Anything free is typically of negligible value — a far cry from the $294.60 per bitcoin owned. In other words, receiving free money is like coming across a flying unicorn or a Bigfoot sighting. We dream them to be true, but their existence is highly unlikely. The forked coins resulting from a hard fork come at a cost — namely, the dilution of the original cryptocurrency. If a new coin like BCH were truly free, at no cost to the underlying legacy coin, why not fork to infinity and beyond?

Cryptocurrency Hard Forks

Each time a hard fork occurs, another cryptocurrency is created. The cryptocurrency is only "new," however, in the sense that it has a new name and is traded independently from the legacy coin. The forked cryptocurrency shares the same base software protocol as the legacy currency and, more importantly, the same digital history on the blockchain. Airdropped coins do not carry such electronic genetics.

To understand the difference between an airdropped coin and a forked coin, it is essential to first understand how cryptocurrency hard forks work.[10] A cryptocurrency coin is a tradable digital asset that is created and transferred on a digital ledger known as the blockchain. As the name indicates, a blockchain is a series of blocks linked to each other in an append-only data structure. Each block contains ledger entries recording transactions involving the cryptocurrency — specifically, transactions that create or transfer coins.

In bitcoin (and BCH), blocks are created and transactions verified through a process known as mining: Miners compete with each other to solve cryptographic puzzles that give them the right to add a new block to the official blockchain, and are rewarded with a fixed number of newly minted bitcoins.[11] All transactions involving the cryptocurrency that have ever occurred are recorded on the blockchain ledger, multiple copies of which are maintained by participating users on a public peer-to-peer network.

Every cryptocurrency is governed by a software protocol that specifies all aspects of the currency architecture, including block size, method of creating new coins, and format for transaction entries. Most cryptocurrencies are supported by a group of developers who maintain the software code, periodically making minor and major updates. When a major upgrade is released, all the miners generally agree to update their software, and mine future blocks under the modified protocol. Thus, software updates do not result in the creation of a new cryptocurrency.[12]

But sometimes a split occurs among groups of miners and developers who disagree about the future direction of the cryptocurrency. In this case, the cryptocurrency undergoes a hard fork and splits into two cryptocurrencies: the legacy cryptocurrency and the forked cryptocurrency. The legacy currency will be governed by the original software while the forked currency will be governed by software modified by the renegade developers. The hard fork occurs at a specific block in the historic blockchain. From that point, each currency will be maintained on a separate blockchain: Some miners will add new blocks to the legacy blockchain, while others will add blocks to the forked blockchain. Because both cryptocurrencies share the same blockchain (that is, history of transactions) up to the point of the fork, all owners of a coin of the original currency will automatically own both a coin of the legacy currency and a coin of the forked currency.[13] It is this juncture at which the IRS is incorrect in its recent revenue ruling.

Hard Forks vs. Airdrops

A hard fork is nothing more than a split of the blockchain that results in the division of the original cryptocurrency's coins. The mere division of an asset does not rise to the level of a realization event. After a hard fork, the legacy coin and the forked coin share a common history on the historic blockchain. The pre-fork events that gave rise to a specific coin of the original currency or resulted in its transfer are part of the common history of both coins. That is, even though the legacy coin and the forked coin can only be transferred separately after the fork, each coin was literally created and transferred in the same transactions that occurred before the fork.

In some respects the historic blockchain is similar to the DNA that a racehorse dam shares with her newborn foal.[14] It is like the common chain of title that two lots share following the division of a parcel of land (regardless of whether it was voluntarily partitioned).[15] In *Gamble*, the Tax Court did not offer an opinion on whether income was realized on the birth of the foal, which had been in utero when the dam was purchased. Likewise, in *Heiner*, the Supreme Court did not consider whether the partition of the parcel gave rise to a realization event. In neither case did the courts consider whether the taxpayers were receiving something for free. The foal's birth and the land partition were clearly non-realization events. Both cases instead addressed the issue of how the taxpayer's basis should be allocated. In *Gamble*, although the foal was clearly different in kind than the dam (like the forked and legacy cryptocurrencies), the Tax Court found that a portion of the price paid by the taxpayer to acquire the dam at auction should be allocated to the foal when it was later sold.

Before Rev. Rul. 2019-24, the only official guidance regarding cryptocurrency was Notice 2014-21, 2014-16 IRB 938,[16] which was issued before the BCH hard fork had occurred, and thus unsurprisingly did not address the issue. In the absence of administrative guidance, various legal theories have developed on the proper tax treatment of hard forks.[17] The American Bar Association[18] and the American Institute of CPAs[19] have weighed in on the issue. Both suggest that the IRS provide a safe harbor or election for 2017 under which the BCH fork (and other forks that occurred during that year) are treated as realization events. Unlike the IRS, both groups recommend that the value of the forked currency be recognized as zero at the time of the fork.[20]

Although academics and commentators held differing views regarding hard forks, one clear issue was the proper treatment of an airdrop. An airdrop occurs when the holder of a cryptocurrency receives an unrelated currency on a promotional basis. This typically results from a marketing strategy by the creators of a new cryptocurrency to attract attention to an initial coin offering.[2] Coins or tokens issued in an initial coin offering often entitle the owners to use a product or service that the issuer provides, so the promotional coins are intended to attract attention to those products or services in addition to promoting the new coin itself.

Airdrops can be equated to free food samples offered at Costco — largely worthless initially. They have zero historical linkage on the blockchain to the cryptocurrency holdings they are dropped on. In the tax world, airdrops are most similar to the receipt of a prize or treasure trove. They should be treated as ordinary income equal to their FMV under section 61. While not expressly listed in section 61, prizes, treasure trove, and airdrops all fall within the broader category of "income from whatever source derived."

Crossing the Analytical Streams

The IRS fundamentally confuses hard forks with airdrops, reminiscent of crossing the streams in the 1984 movie *Ghostbusters*. As Harold Ramis informs Bill Murray in the movie, crossing the streams is "bad . . . very bad!" But, like Murray, the IRS appears "fuzzy on the whole good/bad thing." Intending to address the proper tax treatment for the BCH hard fork (and other hard forks), the ruling provides two examples that demonstrate the IRS's misunderstanding of the distinction between an airdrop and a hard fork.

The examples clearly illustrate that the IRS does not understand that owners of an original coin *automatically* become owners of the forked coin (on a 1:1 basis) as a result of a hard fork. Instead, the IRS suggests the original coin owners can come to own forked coins only if they later receive them through an airdrop. Readers of the ruling who are knowledgeable about cryptocurrency are left scratching their heads in both examples about what happened to the coins created through the hard fork. The forked coins seem to have disappeared — only to reemerge if the fork is followed by an airdrop. It is anybody's guess who, if anyone, owns the disappearing forked coins immediately after the fork.

In the first example, the ruling describes a situation in which Taxpayer A owns 50 units of a cryptocurrency (Crypto M). The ruling indicates that Crypto M experiences a hard fork, resulting in the creation of a new currency (Crypto N), but then states, "Crypto N is not airdropped or otherwise transferred to an account owned or controlled by A."[22] The ruling then concludes that the taxpayer does not have gross income under section 61 because no units of the new cryptocurrency were received. The ruling shows that the IRS does not understand that the taxpayer will automatically own the new cryptocurrency if the original currency does indeed undergo a hard fork.[23]

In the second example, the ruling describes a situation in which a different taxpayer (B) owns 50 units of a cryptocurrency (Crypto R). This cryptocurrency also experiences a hard fork, resulting in the creation of a new currency (Crypto S). In this example, the taxpayer *does* receive units of the new cryptocurrency, but the units are received through an airdrop instead of by virtue of the hard fork itself. To be specific, the taxpayer receives 25 units of Crypto S that are worth $50. The airdrop is the sole way the taxpayer obtains ownership of units of Crypto S. This is clear because the example states that the taxpayer owns only 25 units of Crypto S rather than the 75 units the taxpayer would own if 50 units had automatically been created in the hard fork. The ruling concludes that this taxpayer realizes and recognizes $50 of ordinary income because Crypto S represents an accession to wealth that the taxpayer has dominion and control over.

The problem with the ruling is that it blurs the analytical lines between a hard fork and an airdrop. The tax law is clear on airdrops. An airdrop involves an entirely unrelated cryptocurrency that is received for free. Any holder of a cryptocurrency can receive an airdrop — receipt eligibility has nothing to do with whether the currency has undergone a hard fork. Currency received in a hard fork, on the other hand, is not free in any sense of the term. It comes at a cost borne by the legacy currency. As discussed above, a hard fork is similar to the partition of a parcel of land into lots. It is also similar to a nontaxable stock split.

Circling back to Ramis's warning that something very bad will happen if you cross the streams: While all life as we know it may not stop and every molecule in our bodies may not explode at the speed of light as a consequence of crossing these analytical streams, there is up to $2.5 billion in potential 2017 tax revenue at issue. The IRS must get this one right. Perhaps once the IRS understands how hard forks work, it may lean more toward a division analysis. Despite that, if the IRS really believes that obtaining forked currency is a realization event, it is imperative that the agency accurately describes the event taking place. It is entirely possible that taxpayers and practitioners will take the position that the ruling does not apply to their situations because their BCH coins were not received via an airdrop, but rather a hard fork.

The Realization Requirement

It is worrisome that the IRS is fuzzy on distinguishing between an airdrop and a hard fork. That confusion indicates that the IRS does not fully appreciate or understand the event or nonevent transpiring when a hard fork occurs. The IRS's legal analysis makes no mention of the seminal U.S. Supreme Court case, *Macomber*.[24] As clarified by the Court, the mere division of an asset (such as a stock split) does not give rise to a realization event. The taxpayer receives nothing new — and nothing is taken away — when an asset merely splits. While one may have what appears to be a new asset, it is fundamentally nothing more than a part of the old asset. For example, when one takes the tires off of a vehicle, no one would argue there should be any income tax consequences.

Although the IRS failed to mention *Macomber* in its ruling, the U.S. Supreme Court's holding in *Glenshaw Glass*[25] was referenced. *Glenshaw Glass* provides that income is realized when there is an "undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion." *Macomber* and *Glenshaw Glass* work together: They are two sides of the same coin. The airdropping of free cryptocurrency into a bitcoin owner's electronic wallet would indeed be an event that meets the *Glenshaw Glass* requirements. Obtaining cryptocurrency from a hard fork is an entirely different matter — it does not constitute an accession to wealth but is instead a division of an existing asset that is not a realization event, consistent with the stock dividend in *Macomber* that merely diluted (that is, divided) the taxpayer's stock holding.

Conclusion

It is unreasonable for the IRS to create an artificial realization event for taxpayers who received BCH. Many bitcoin holders had no voice in the creation of BCH. It is inequitable to require them to realize income because of an asset division that was forced upon them by unrelated parties. Those who received forked BCH and who held onto it should not have income tax consequences. The IRS is manufacturing a nonexistent realization event: A division is not a realization event.

Airdrops, in contrast, result in clear realization because cryptocurrency owners are receiving something new. Hard forks, however, are significantly more complicated. Their creation strikes at the heart of our constitutional notions of income. Forcing realization creates taxpayer fairness issues, administrative issues, and wherewithal-to-pay issues. These magical airdrops of cryptocurrency in the context of hard forks — as the IRS suggests in the ruling — simply do not occur. We recommend the IRS revoke the ruling and go back to the drawing board on hard forks. Leave the airdrops to the food sampling stations at Costco.

FOOTNOTES

[1] BCH is the official ticker for bitcoin cash. BTC is the ticker for bitcoin.

[2] *See* Stan Higgins, "Bitcoin Cash Just Mined Its First Block, Making Blockchain Split Official," CoinDesk, Aug. 1, 2017.

[3] *See* Luke Graham, "A New Digital Currency Is About to Be Created as the Bitcoin Blockchain Is Forced to Split in Two," CNBC, July 31, 2017. The maximum block size for bitcoin transactions was (and is) one megabyte. Under the BCH software protocol, block sizes up to eight megabytes are possible.

[4] For simplicity, we refer to full cryptocurrency coins as the unit of measure. It is possible to own a fractional unit of a coin. For example, a satoshi — the smallest unit of bitcoin — is worth one 100-millionth of a bitcoin. All statements regarding bitcoin or BCH coins apply to fractional coins as well.

[5] Data from coinmarketcap.com.

[6] Based on the highest individual tax rate in effect in 2017 of 39.6 percent and assuming all owners are U.S. persons.

[7] In general, the IRS must assess additional tax and propose penalties no later than three years after the later of when a tax return is filed or its due date; that becomes six years if the tax return omits items of income exceeding 25 percent of the gross income. If no return is filed or the return was filed fraudulently with the intent to evade tax, tax may be assessed at any time. Section 6501. Thus, if the taxpayer timely filed a 2017 return on April 15, 2018, tax may be assessed until April 15, 2021. If the taxpayer failed to report income from the BCH fork that was greater than 25 percent of gross income, that date becomes April 15, 2024.

[8] Rev. Rul. 2019-24. For coverage, see Nathan J. Richman and Kristen A. Parillo, "IRS Rules New Cryptocurrency From Hard Forks Is Taxable," *Tax Notes Federal*, Oct. 14, 2019, p. 311.

[9] The ruling speaks only to the taxability of new cryptocurrency received through an airdrop. Because the new cryptocurrency obtained in a hard fork is not received in an airdrop, the ruling does not technically apply, but it seems the IRS intends to treat all events in which a taxpayer obtains a new cryptocurrency as taxable.

[10] For an easily understandable discussion of the inner workings of cryptocurrencies like bitcoin, see Jan Felix Hoops, "An Introduction to Public and Private Distributed Ledgers," in *Proceedings of the Seminars Future Internet (FI) and Innovative Internet Technologies and Mobile Communication (IITM)* 41-48 (Sept. 2017/2019). For a good description from the perspective of tax professionals, see Mary F. Voce and Pallav Raghuvanshi, "Blockchain and Cryptocurrency: Federal Income Tax Issues," *Tax Notes*, Nov. 26, 2018, p. 1077. Note:

Voce and Raghuvanshi mix up the terms "soft fork" and "hard fork" in their initial explanation at page 1081, but correct themselves when they analyze the tax effects of forks at pages 1089-1090.

[11] Mining is the only way new coins are created in bitcoin (and BCH). Other cryptocurrencies use other methods to create new blocks, such as proof-of-stake, which involves validators instead of miners. For simplicity, we use the term "miners" in this article.

[12] Such an update is what some might call a "soft fork," especially if the miners do not all upgrade their software at once and the blockchain temporarily splits. Unlike "hard fork," there is no single agreed-on definition of "soft fork" in the cryptocurrency community. A key distinction, however, is that a soft fork never results in a permanent split of the blockchain or the creation of a new cryptocurrency.

[13] However, the owner may not have dominion and control over the forked currency if, for example, the owner holds the original currency on an exchange that does not immediately recognize the new currency.

[14] *Gamble v. Commissioner*, 68 T.C. 800 (1977).

[15] *Heiner v. Mellon*, 304 U.S. 271 (1938).

[16] The chief contribution of Notice 2014-21 was the conclusion that cryptocurrency should be treated as property rather than currency.

[17] *See, e.g.*, Voce and Raghuvanshi, *supra* note 10, at 1089-1891; Stevie D. Conlon, Anna Vayser, and Robert Schwaba, "Taxation of Bitcoin, Its Progeny, and Derivatives: Coin Ex Machina," *Tax Notes*, Feb. 19, 2018, p. 1001; Ted R. Stotzer, "A Look Ahead: Virtual Currencies — Gaps, Questions, and Pitfalls," *Tax Notes*, Dec. 17, 2018, p. 1463; Nelson C. Yates II, "Stock or Livestock? Hard Fork Basis Allocation," *Tax Notes*, Jan. 7, 2019, p. 61; and Danhui Xu, "Free Money, but Not Tax-Free: A Proposal for the Tax Treatment of Cryptocurrency Hard Forks," 87 *Fordham L. Rev.* 2693 (2019).

[18] *See* ABA Section of Taxation, "Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017" (Mar. 19, 2018).

[19] *See* AICPA, "Updated Comments on Notice 2014-21: Virtual Currency Guidance" (May 30, 2018).

[20] This would be similar to profits-only interests that are received in the partnership context.

[21] Katalyse.io, "What Are 'Airdrops' in Crypto World," Hackernoon (Oct. 14, 2019).

[22] Note that, as explained in this article, the forked coin is not "otherwise transferred" through the fork. There is no "transfer" any more than there is when an ownership interest in a parcel of land is divided into ownership of two lots after a partition. The same owner continues to own the coins or the land throughout.

[23] It is also clear that the IRS is not mixing up hard forks and soft forks because a soft fork would not result in the creation of a new cryptocurrency. *See supra* note 12. Nor is the IRS implying that the taxpayer does not own the forked currency merely because the currency is dropped on a wallet managed through a cryptocurrency exchange that does not recognize the new currency and therefore does not credit it to the taxpayer's account. Although the ruling specifies that taxpayers in that situation would not have income because they do not have "dominion and control" over the income, the second example by its terms involves a case in which the taxpayer *does* have dominion and control and yet the ruling still misconstrues how coin ownership works in the context of a hard fork.

[24] *Eisner v. Macomber*, 252 U.S. 189 (1920).

[25] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

END FOOTNOTES

Cryptocurrency Customer Compliance

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By

LEE A. SHEPPARD
Contact Author

A year or so ago, both Jamie Dimon of JPMorgan Chase and the grandees of the Bank for International Settlements (BIS) denounced bitcoin as a Ponzi scheme. The BIS scolded young people to stop trying to create money. Now JPMorgan is in bitcoin and the BIS has changed its tune, although it recently denounced Facebook's attempt to create a stablecoin.

Cryptocurrency is an East Coast versus West Coast problem. On the West Coast, proponents believe they're creating a brave new world, connecting people, enabling the unbanked, with their vague good intentions marred by a belief that Washington's rules don't apply to them. On the East Coast, business and government are controlled by financiers, and there are rules. Cryptocurrency is a financial instrument, and the East Coast is going to shoehorn it into their rules.

Bitcoin is not a currency. It's no longer being used as a medium of exchange. It is theoretically possible to buy a cupcake with a tiny portion of a bitcoin, but no one in his right mind is doing that because the price fluctuates so much.

So bills in Congress that would excuse bitcoin transactions of $600 or less from being treated under barter rules are pointless (H.R. 7356). More to the point is recent IRS guidance about how to account for basis in bitcoin transactions and recognition events like forks and airdrops.

Bitcoin became an investment asset when it appreciated wildly, and its status as such was cemented when the Commodity Futures Trading Commission gave permission for bitcoin futures. That was also when bitcoin became a short. It was deliberate. The CFTC granted permission to create futures for the purpose of stopping the 2017 run-up in bitcoin.

That's what former CFTC Chair Christopher Giancarlo told the recent Pantera Blockchain Summit in San Francisco. Seems the administration regarded the 2017 appreciation of bitcoin as a post-2008 bubble that had to be pricked, and the way to do so was to bring cynical institutions into trading. Treasury, the SEC, and then-National Economic Council Director Gary Cohn approved the move. Bitcoin's price fell from $20,000 to $3,000 (Coindesk, Oct. 22, 2019).

"We saw a bubble building, and we thought the best way to address it was to allow the market to interact with it," Giancarlo said. Markets need short interests. "If you do believe it's a ridiculous price but you don't own, there's no way to express that view," according to Giancarlo. "If you don't have that derivative, then all you've got are believers, [and] it's a believers' market." Bitcoin futures trade on the Chicago Mercantile Exchange (CME) and the CBOE Futures Exchange (CFE).

Indeed, without institutions participating, cryptocurrency prices mostly respond to the level of Google searches. British financial authorities are not as enchanted with cryptocurrency derivatives. The British Financial Conduct Authority proposed to ban sales of crypto derivatives to retail investors after BitMex made a margin call when the price of bitcoin melted down recently (*The Economist*, Oct. 5, 2019).

Meanwhile, crypto promoters are bemoaning the lack of a purchaser of last resort — a market maker — in their phony markets. Fiat money washes in. Fiat money washes out. The dumb money needs to be educated about cryptocurrency as an asset, apparently, so they will put more fiat money into it and push the prices up. Well, gee, would a recession or a repo market failure help bitcoin? Er, um, no, everything tends to fall at once, and cryptocurrency is not a hedge against everything else (Coindesk, Oct. 25, 2019).

Bitcoin might even become obsolete with Google's recent claim of successful quantum computing. Google claims that its cryogenically cooled 54-qbit Sycamore processor made a calculation in 200 seconds that would have taken IBM's most powerful supercomputer 10,000 years to process. IBM disagreed, saying it would take only 2½ days. Google conducted this experiment to show that quantum computing could scale up, which until now has been theoretical. Nonetheless, if it ever becomes practical, quantum computing could break the 256-bit bitcoin blockchain relatively quickly. It may also be able to break encrypted military communications (*Nature*, Oct. 23, 2019).

QUANTUM COMPUTING WILL DESTROY BITCOIN IF IT EVER BECOMES PRACTICAL. (COVER IMAGES/ZUMA PRESS/NEWSCOI

Meanwhile, the IRS has a crypto nonreporting crisis on its hands. That's nonreporting as in not reporting anything. The IRS sent three types of letters, of varying degrees of urgency, to 10,000 of the 13,000 holders named pursuant to the Coinbase summons that it believes have not reported any transactions (IR-2019-132). Of roughly 40 million cryptocurrency accounts, only about 1,000 have reported, according to the IRS.

No fewer than five panels at the recent American Bar Association Section of Taxation meeting in San Francisco discussed how investors should account for cryptocurrency gains and losses. Lawyers who specialize in crypto taxation exhibited surprising faith in these dodgy assets. John van Loo of Belcher, Smolen & Van Loo LLP, who accepts bitcoin, joked that he did better in bitcoin than in legal services. Another lawyer was also a miner. At none of these five sessions did anyone mention that a chastened Coinbase is helping its customers report with TurboTax.

Just after the meeting, the IRS released compliance guidance for cryptocurrency investors. The IRS published Rev. Rul. 2019-24, 2019-44 IRB 1004, raising more questions than it answered, and FAQs offering practical advice on its website, mostly sending people to Publication 544. The IRS guidance is only for taxpayers for whom cryptocurrency is a capital asset. Eventually the IRS will have to think about traders and institutions that treat it as inventory.

The ruling and the FAQs differentiate virtual currency from cryptocurrency, as if they didn't all use elliptic curve cryptography, to make the point that the IRS doesn't care about your son's Fortnite use and his nonconvertible virtual currency (you, however, should care).

There were no surprises, and some conclusions ought to be obvious by now. As Notice 2014-21, 2014-16 IRB 938, stated, cryptocurrency is not foreign currency subject to section 988, because it is not legal tender or issued by a government. Investors had wanted foreign currency characterization so they could take losses incurred in 2017 when bitcoin futures began trading. The bursting of the bitcoin bubble cost investors $5 billion. Before the Tax Cuts and Jobs Act restricted like-kind exchanges to real property, some investors were taking the even more untenable position that they could make like-kind exchanges of cryptocurrencies (section 1031(a)(1)).

Love Letters

Takeaway: Clients in receipt of IRS soft letters should take action to comply.

The Coinbase subpoena proved that tax dodging is tax dodging — only the mechanism differs. The ensuing IRS letters probably weren't about the bitcoin hard fork — which Coinbase did not support — but were more likely to have been about more straightforward conversion of bitcoin into dollars and Lamborghinis. The Coinbase summons enforcement order gave the IRS access to account holder information for conversions of cryptocurrencies into cash during the years 2013 to 2015 (*Coinbase Inc. v. United States*, No. 3:17-cv-01431 (N.D. Cal. 2017)).

Letter 6173, the most serious of the bunch, requires the taxpayer to either file returns or submit information and sign the jurat at the bottom of the page, acknowledging that statements required in response are true, correct, and complete. Letters 6174 and 6174-A are gentler and went to smaller fish, but warn recipients that the IRS has information about their holdings.

Steven Toscher of Hochman Salkin Toscher Perez PC advises crypto holders to take their soft letters from the IRS very seriously. "In my experience, many clients who received a letter may have already made a good-faith effort to report their taxable transactions," he said. "For others, a letter is a good reminder to consider corrective action, such as filing amended returns or utilizing the more formalized voluntary disclosure." He advises clients to file amended returns on which they pay all taxes and interest due.

> ***The Coinbase subpoena proved that tax dodging is tax dodging — only the mechanism differs.***

Voluntary disclosure would be advisable for clients with criminal exposure, according to Toscher. As Darren Guillot, deputy commissioner for collections and operations support, IRS Small Business/Self-Employed Division, noted at the ABA Civil and Criminal Tax Penalties Committee session, receipt of a letter would not disqualify a taxpayer from entering voluntary disclosure. More guidance on that point will be coming shortly. "This is your last chance to come in to correct. Don't just sign the letter," said Guillot. (Prior coverage: *Tax Notes Federal*, Oct. 14, 2019, p. 365.)

What kind of a case is a possible criminal case? Some investors named in response to the Coinbase summons moved their wallets to unreported offshore exchanges (which cannot be compelled to report). That may be a potential criminal case. "You are hitting on two high-priority targets of the government," Toscher observed.

Factors Toscher would consider include amounts involved; number of years involved; the background of the taxpayer — is it Mother Teresa or Al Capone; factors supporting good faith and a lack of willfulness; reliance upon a professional or one who appeared to be an expert; age and experience of the taxpayer, including accounting and tax experience; and government priorities.

Government priorities? The government is looking for bitcoin whales. "This is where a case which otherwise might lack some really good prosecution factors would be more attractive if it involved cryptocurrency because the DOJ and the IRS are looking for general deterrence," Toscher noted.

Letter 6173, which goes to individuals whom the IRS believes did not report, refers to the possibility of criminal penalties. "We have a massive compliance problem. . . . [Criminal Investigation] is active in this area. The exam agents are active in this area. We have 10,000 letters out there. There will be more enforcement activity," warned IRS Chief Counsel Michael J. Desmond, a surprise guest at the ABA Financial Transactions Committee.

He added that the IRS is looking into its authority to require information reporting on cryptocurrency transactions (section 6031). The largest exchange, Coinbase, only issues Form 1099-K to holders with $20,000 and 200 transactions, as the law prescribes.

Under the restated voluntary disclosure program, the requirements are six years of amended returns plus a civil fraud penalty for the highest income tax year (LB&I-09-1118-014). The new Form 14457, "Voluntary Disclosure Practice Preclearance Request and Application," includes a question on cryptocurrencies. Voluntary disclosure also requires other disclosures, like FBAR.

The IRS confirmed in FAQ 35 that moving cryptocurrency to another exchange or wallet is not itself taxable. Is a foreign cryptocurrency wallet a foreign financial account? "If the account is maintained in a foreign jurisdiction and looks and feels like a foreign financial account, it probably is," Toscher said, adding that he would have to look at details of the holding and analogize it to other financial accounts. He would report foreign cryptocurrency accounts on FBARs filed with a voluntary disclosure.

Lawyers disagree about whether a foreign cryptocurrency account is reportable under FBAR. "We have received requests for additional guidance on foreign reporting and are coordinating those with FinCEN and other stakeholders," Desmond told *Tax Notes*.

Some advisers take the position that it is not reportable. In its comments on Notice 2014-21, the American Institute of CPAs argued that a cryptocurrency wallet held on a foreign exchange should be reportable on FBAR, but cryptocurrency held offline should not be, that is, a personal wallet resides wherever the individual resides.

FinCEN indicated to the AICPA that virtual currency held in an offshore account is not a foreign account that needs to be reported on an FBAR. FinCEN told the AICPA that it, "in consultation with the IRS, continue[s] to evaluate the value of incorporating virtual currency held offshore into the FBAR regulatory reporting requirements."

At the ABA Sales, Exchanges & Basis Committee meeting, Annette Nellen of San Jose State University commented that Congress would have to say whether a foreign wallet should go on an FBAR. Some clients are filing FBARs. There is no line for cryptocurrencies on Form 8938, the tax return analogue of FBAR. The ABA tax section asked for FBAR guidance and an extended period to file amended returns without penalty (reg. section 1.6664-2(c)).

"There are some instances where clients have made a good-faith effort to report and may have already been substantially compliant," Toscher explained. "In these instances, it is conceivable that after a careful review of the issue, no further corrective action is recommended." Letters 6174 and 6174-A are warnings that may not require a response.

If lawyer and client conclude that there was a good-faith effort to report properly, should the client nonetheless respond to a Letter 6174 or 6174-A? "A response to the IRS letter communicating the nature of the internal review done and that no corrective action is needed may be an appropriate response in some instances," said Toscher. Even the recipients of these milder letters have no guarantees that they will not be examined. There will be more letters. (Prior coverage: *Tax Notes Federal*, Oct. 28, 2019, p. 652.)

But don't lie to the IRS. "An important caveat — if you say anything in response to one of these letters, make sure it is truthful. False statements can be a felony even if not under penalty and also be considered a badge of fraud. Silence may be the best alternative," Toscher cautioned.

Are there penalties for having gotten it wrong on previous returns? Notice 2014-21 warned about penalties for failure to report bitcoin transactions before it was issued. The new FAQs don't mention penalties, but the soft letters do.

Toscher doesn't think the IRS would pursue penalties on older transactions. "It will depend, but I think in many cases the IRS will not assert penalties. There is a question about whether amended returns will be considered qualified amended returns," he said. "But in order for them to assert penalties, they have to examine or write up a report. Also note the letters were silent about the penalties on any amended return. I guess being conservative, I would tell a client to expect an accuracy-related penalty — but I am not convinced the IRS will go there in most cases."

Amended returns can be admissions. "The benefit of amended returns is that it corrects the noncompliance and could offer a mechanism for reduced or eliminated penalties, such as qualified amended returns. The downside of the amended returns is that they can serve as admissions that can assist in an IRS ongoing investigation or with the assertion of fraud penalties," Toscher noted.

Monte A. Jackel complained in comments to the IRS that the FAQs do not provide protection from penalties (reg. section 1.6662-4(d)(3)(iii)). "Why provide guidance that can be changed without public notice and comment and that apparently cannot even provide penalty protection as the 2014 notice does?" he asked rhetorically. "Actual reliance on FAQs would be a factor in determining whether a taxpayer acted with reasonable cause and in good faith so as to avoid accuracy-related penalties," Desmond told *Tax Notes*.

Jackel also argued that a revenue ruling was not the appropriate vehicle for cryptocurrency guidance. "Revenue rulings published in the Internal Revenue Bulletin can be appropriate in circumstances like this where existing law is being applied to a new or unique factual scenario," Desmond told *Tax Notes*.

But lawyers representing bitcoin investors do not believe that penalties would be sustained for periods before 2014, when the IRS announced its view that bitcoin is property.

"Determining whether to assert penalties, and whether a taxpayer may have a defense to penalties, depends on the facts of each case. Until a particular return is examined, the IRS cannot determine whether the assertion of penalties is appropriate," Desmond told *Tax Notes*.

Mutual Funds

Takeaway: Crypto exchanges are a lot like mutual funds.

The enactment of cost basis reporting rules in 2008 demonstrated just how haphazard compliance with individual reporting has been for easily priced assets like listed shares (section 6045). There are not that many taxable investors, but before basis reporting they may have been just making it up. If this was going on for listed shares, it is hard to expect cryptocurrency investors to reconstruct basis.

"A big hurdle is the lack of documentation that historically existed with respect to cryptocurrency transactions," Toscher said. "Some cryptocurrency exchanges maintain better records now, but may not have for earlier years."

> ***Specific identification is difficult for most crypto holders.***

Let's start with the law. Cryptocurrency isn't a security, so specific identification is the default rule (reg. section 1.1012-1(c)). Crypto advisers requested average cost basis reporting. Specific identification is difficult for most crypto holders. Some more sophisticated holders are able to make a specific identification of cryptocurrency bought or sold.

For a holder on an exchange, bitcoin is analogous to a mutual fund. As the discussion in the Financial Transactions Committee established, most holders have wallets on exchanges. That is, they hold an undifferentiated portion of an omnibus account of bitcoin or other cryptocurrency held by a cryptocurrency exchange like Coinbase. Their ownership is akin to a mutual fund shareholder's indirect, undifferentiated ownership of the fund's portfolio.

"If I hold a wallet [on an exchange], I don't own a particular bitcoin," said Rebecca E. Lee of PwC at the Financial Transactions Committee meeting. "While, when I made the acquisition, a particular internet location was purchased on my behalf, at any given time, I may not know which assets I hold and which I disposed of."

"The most compliant investors know some things but not everything. I have this much bitcoin. I have this much basis, and I have aggregate proceeds from sales. Trying that out on a transaction-by-transaction basis is incredibly difficult," Lee said. Yet investors need to know these things to properly respond to the IRS letters, Stevie Conlon of Wolters Kluwer pointed out.

"Well, can't someone give you that reporting?" Lee asked rhetorically. Can't the exchange where the wallet is maintained give investors that? Exchanges aren't set up to do that. Tax advisers have requested guidance for basis pooling and blended basis, like that used for mutual funds. Otherwise, investors have to do lot-by-lot accounting.

Yet even if the holder knew what his lots were and when he bought them, his exchange would not be able to accept specific lot instructions, according to Lee. "It is not possible, even if I wanted to, to provide instruction to my exchange about which asset I'm selling," said Lee, noting that the onus is on the taxpayer to instruct the exchange. Most cryptocurrency exchanges are not set up to take those instructions. An exchange would simply debit the designated number of bitcoin. The exchange merely tracks debits and credits from a holder's wallet.

Basis tracking, whether for taxable or nontaxable transactions, is difficult, Lee noted. "Of all the assets that you would think we could track in real time . . . given the sawtooth of valuation within each day," Conlon sighed. One would think that, what with the whiz-bang blockchain technology that is ostensibly immutable and all-knowing, tracking tax basis would be an easy programming step. One would be wrong.

> ***For a holder on an exchange, bitcoin is analogous to a mutual fund.***

"It's an old-school problem. All of these assets are held in the equivalent of an omnibus account," said Lee. "What the exchange has done is moved a bitcoin from their proprietary account into the account that is held on behalf of customers," when the latter make a purchase. And the customer's account is debited when he makes a sale. "Nothing actually moves in or out," said Lee. So a whole new system would have to be built to track tax basis for each customer's debits and credits.

Yet the IRS FAQs operate on the view that specific identification is feasible. FAQ 36 states: "You may choose which units of virtual currency are deemed to be sold, exchanged, or otherwise disposed of if you can specifically identify which unit or units of virtual currency are involved in the transaction and substantiate your basis in those units."

FAQ 37 continues, as though the customer knows his private keys:

> You may identify a specific unit of virtual currency either by documenting the specific unit's unique digital identifier such as a private key, public key, and address, or by records showing the transaction information for all units of a specific virtual currency, such as Bitcoin, held in a single account, wallet, or address. This information must show (1) the date and time each unit was acquired, (2) your basis and the fair market value of each unit at the time it was acquired, (3) the date and time each unit was sold, exchanged, or otherwise disposed of, and (4) the fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit.

FAQ 25 recognizes that customers buy cryptocurrency on exchanges. Some sort of method other than specific identification was administratively necessary. FAQ 38 states: "If you do not identify specific units of virtual currency, the units are deemed to have been sold, exchanged, or otherwise disposed of in chronological order beginning with the earliest unit of the virtual currency you purchased or acquired; that is, on a first in, first out (FIFO) basis."

This is a good deal for crypto investors. FIFO is normally allowed only for marketable securities. Could exchanges and their customers even comply with FIFO? The bitcoin hard fork and the attendant losses sparked interest in basis tracking and prompted the development of cleverly named tech firms that purport to resolve the problem for holders.

"The lack of reporting by exchanges and platforms is an issue, but it is slowly being addressed through initiatives such as: (1) exchanges pairing with tax software companies specializing in reporting and return preparation; and (2) service providers that are able to aggregate a taxpayer's crypto asset transactions across wallets and exchanges," said Nicholas Mowbray of BakerHostetler.

Most of the new compliance and reporting tools are for accounting firms and fund managers. A lot of hedge funds own cryptocurrencies. But Coinbase recently announced that it has a deal with TurboTax that will allow its retail customers to upload their transactions to TurboTax Premier, which assists them in differentiating taxable from nontaxable transactions. Coinbase also offers tax resources, but not advice, to customers (Coindesk, Jan. 24, 2019).

Wouldn't average cost basis have made more sense for cryptocurrencies held at exchanges? Weirdly, there are still barriers to the use of average cost basis for securities (reg. section 1.1012-1(e)). The Senate version of the TCJA would have mandated FIFO or average cost basis for securities, but the final bill did not adopt this provision.

If crypto exchanges are essentially mutual funds, should they be governed by subchapter M? Technically, they aren't regulated under the Investment Company Act of 1940 (section 851(a)(1)). Perhaps they should be, but the SEC hasn't woken up to that problem yet.

Coinbase says it is not an investment adviser or broker. Nonetheless, mutual fund holder treatment provides a useful model for cryptocurrency exchanges, Lee acknowledged.

Alternatively, Lee suggested the widely held fixed investment trust (WHFIT) reporting rules as a model for crypto exchange customer taxation (T.D. 9308). The WHFIT rules have been hanging around since 2006, but the IRS is looking to reduce the burden of them (83 F.R. 42356).

A WHFIT is defined as a trust that is a U.S. person treated as owned by its beneficiaries, with at least one interest held by a middleman (section 7701(a)(30)(E); reg. sections 1.671-5(b)(22), 301.7701-4(c)). All items of income, expense, credit, and asset sales must be reported on Form 1099 by the trustee or middleman, which can choose its own calculation period (reg. section 1.671-5). Interest and original issue discount earned by WHFITs are reportable (reg. section 1.6049-5).

The WHFIT rules look through the trust to treat a beneficial owner as the owner of an undifferentiated share of the underlying assets for purposes of in-kind redemptions (reg. section 1.671-5(b)(8)). These rules achieve great simplicity by allowing trust beneficiaries to report factors for their per unit gains and losses (reg. section 1.671-5(c)(2)(ii)-(iv)). Even though Coinbase isn't organized as a trust, it behaves like one, because it treats customers as owners of the underlying assets in its omnibus cryptocurrency account.

Coinbase is a corporation registered as a money transmitter with FinCEN and has to comply with the Bank Secrecy Act and PATRIOT Act (it keeps customer dollars in a bank and a customer must link a bank account). In its user agreement, Coinbase maintains that the customer is the owner of cryptocurrency in his wallet and bears the risk of loss. Coinbase is a mere custodian of public and private keys; the agreement speaks of a deposit. But it makes the point that customer interests in cryptocurrency are not segregated — that's the omnibus account.

Readers, you don't own the securities in your margin account. You don't even own the funds in your checking account. Neither of those accounts is a bailment. Coinbase doesn't run its business this way. It says that an account with it is a bailment, and that it is a mere custodian of cryptocurrency. Maybe this is a relic of an earlier time when customers deposited their own private keys with the exchange rather than buying their cryptocurrency on the exchange. Coinbase maintains that although the customer owns cryptocurrency associated with his private key, it all goes into an undifferentiated crypto pool at the exchange.

The omnibus account on crypto exchanges calls for batch basis reporting concepts. "That is the fundamental policy argument for blended or pooled basis reporting," said Lee, who likes the WHFIT and mutual fund models. "If I own a slice of a mass asset, and I have an undifferentiated asset that I own, it forms an argument for pooled reporting," she said. "These would be very reasonable rules to write that would allow taxpayers to be reasonably compliant," said Lee, adding that the government would need holder information reporting to support exchange-level pooled reporting.

The simplicity of the WHFIT rules lies in reporting that provides investors factors to compute their per unit gains and losses without the necessity of individual lot by lot reporting on underlying assets. The hope is that the IRS could adopt simplified reporting for cryptocurrency so a customer could receive factor reporting similar to what the holders of a WHFIT receive. Lee acknowledged that this would require an entirely new and different reporting regime than what exists today.

Stablecoin is analogous to a money market fund, Lee noted. It's supposed to be liquid, it's supposed to track underlying assets, and it's not supposed to break the buck. Stablecoins are cryptocurrencies backed by cash and other liquid assets. Some even have auditors to monitor their stash. Facebook's Libra is intended to be such an arrangement. There's really no reason not to treat stablecoins as money market funds — the "coin" being analogous to a share in a fund. Stablecoin ought to be regulated under the 1940 Act, but until such time as it takes off, the SEC may take no notice of it.

Meanwhile, the Financial Action Task Force thinks stablecoin poses a money laundering risk in the form of transfers that don't involve regulated intermediaries. It published guidelines for a risk-based approach to analyzing virtual assets and their service providers.

Hard Forks

Takeaway: Bitcoin is not a pregnant cow.

When we talk about hard forks, we're really talking about the bitcoin/bitcoin cash hard fork in August 2017. That hard fork was the result of processing speed arguments between creators and managers. That fork was supposed to replace the original bitcoin, and the old, less sophisticated bitcoin was supposed to fade away. Trouble is, that didn't happen. Old bitcoin didn't fade away — instead bitcoin cash became a new cryptocurrency standing alongside regular bitcoin. Bitcoin holders had the value of their holdings increased, but not doubled. Bitcoin cash didn't take off, but it's still worth something.

The bitcoin hard fork was clearly taxable, despite the best efforts of some lawyers to analogize it to livestock or a stock split (*Eisner v. Macomber*, 252 U.S. 189 (1920)). That was obvious to everyone east of the Mississippi, but was not generally believed on the West Coast, which lobbied Congress to ensure no taxation. One such bill was H.R. 3650, which would prohibit penalties for nonreporting of hard forks in the absence of IRS guidance. The ABA tax section did not cover itself in glory when it argued that the 2017 bitcoin hard fork should not be taxable under current law.

Rev. Rul. 2019-24 explains why a hard fork should be taxable. It differentiates a hard fork in which a taxpayer obtains dominion and control over a new asset from one in which there is no accession to wealth because there has been a mere protocol change. The first situation is described as a hard fork with an airdrop, and clearly describes the bitcoin hard fork. It even discusses the possibility that the exchange would not process the associated airdrop; Coinbase did not support the bitcoin airdrop. The second situation describes an unsupported hard fork.

The IRS FAQs made the point that hard forks are taxable when the holder receives a new asset. "If a hard fork is followed by an airdrop and you receive new cryptocurrency, you will have taxable income in the taxable year you receive that cryptocurrency," FAQ 22 states.

The IRS uses the word airdrop as a generic term to describe any distribution. In IRS thinking, the receipt of cryptocurrency by a miner is an airdrop. That is, the IRS uses the word airdrop to describe any in-kind distribution, regardless of what, if anything, was exchanged for it. Airdrop is a handy way to describe all zero-basis receipts of cryptocurrency income or gain. The revenue ruling describes an airdrop as "a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers."

If the exchange did not support the hard fork, the IRS stated that there is no recognition event. "If your cryptocurrency went through a hard fork, but you did not receive any new cryptocurrency, whether through an airdrop (a distribution of cryptocurrency to multiple taxpayers' distributed ledger addresses) or some other kind of transfer, you don't have taxable income," FAQ 21 states.

FAQ 29 prescribes the same result for a similar transaction, a soft fork, when a protocol change was made to a cryptocurrency without a new asset being created. Bitcoin technically incurs soft forks all the time, when miners compete for blocks. The winner's block survives and the other block dies. Really a soft fork and an unsupported hard fork are the same thing.

Cryptocurrency airdrops are taxable at fair market value at the time of receipt. FAQ 23 makes this statement:

> When you receive cryptocurrency from an airdrop following a hard fork, you will have ordinary income equal to the fair market value of the new cryptocurrency when it is received, which is when the transaction is recorded on the distributed ledger, provided you have dominion and control over the cryptocurrency so that you can transfer, sell, exchange, or otherwise dispose of the cryptocurrency.

And then FAQ 24 describes the fair market value basis resulting from that airdrop income inclusion:

> If you receive cryptocurrency from an airdrop following a hard fork, your basis in that cryptocurrency is equal to the amount you included in income on your Federal income tax return. The amount included in income is the fair market value of the cryptocurrency when you received it. You have received the cryptocurrency when you can transfer, sell, exchange, or otherwise dispose of it, which is generally the date and time the airdrop is recorded on the distributed ledger.

What do you do about valuation? What if the markets are rigged? Outside of bitcoin, which is disciplined by the futures market, the markets are rigged. "People are questioning whether some of the valuations are real," Conlon noted. Some advisers like to use an average of several markets on an average day. There is also a big issue of allocation of basis after a hard fork. If securities methods are to be permitted, the answer for the bitcoin fork would be allocation between bitcoin and bitcoin cash according to fair market value (section 307). (Prior analysis: *Tax Notes*, Jan. 7, 2019, p. 61.)

Death and Taxes

Takeaway: Get your dad's private key before he dies or forgets where it is.

Many readers have aged parents. Your healthy aged parents should be out golfing and enjoying life. Your infirm aged parents should be playing with their robot pets and taking their prescriptions. But we know they're not trying to live out their last years in peace. Nope, they're screaming at partisan TV news and mucking around with their investments on the computer. They've moved on from GLD to bitcoin.

Rich people love the perception of liquidity. As with offshore bank accounts, clients tend not to tell lawyers, fiduciaries, trustees, or family members about the existence of crypto investments. Executors find all kinds of weird things, like gold bars in the basement. They're finding thumb drives and computers containing bitcoin private keys. When a customer dies, Coinbase will freeze his account until a fiduciary has opened a new account and transferred the customer balance. If there is no designated fiduciary, Coinbase will try to find an heir or seek a court order. If Coinbase has unclaimed property, that will revert to the state.

> ***Executors are finding thumb drives and computers containing bitcoin private keys.***

At the ABA tax section Standards of Tax Practice Committee session, Abigail Rosen Earthman of Winstead explained that bitcoin can be held privately, offline, or centrally at an exchange like Coinbase. Bitcoin held privately offline means that the public key and the private key are held separately offline. Earthman's preferred solution is a USB drive held in a safe deposit box. She knows whereof she speaks. She not only owns bitcoin, she mines it with an overheated supercomputer in her living room in Texas.

At the ABA tax section Estate and Gift Taxes Committee session, Earthman, a tax litigator, explained that fiduciaries need to open and examine these items. Don't wipe that computer hard drive. Don't toss those USBs in the desk drawer. An executor has a duty to figure out what a decedent owns, even at the expense of violating the latter's privacy and exchange terms of service agreements. Even emails might contain Coinbase passwords and private keys. A private key is essentially bearer paper, Earthmen cautioned.

She shocked her audience by telling them that people are trying to create self-executing Ethereum blockchain trusts that make automatic distributions. "People are trying to do this. Unfortunately, it's not the right people," Earthman said. It's tech entrepreneurs, who don't hire estate lawyers or anyone versed in fiduciary duties. One website even purports to decide when the trust settlor should be dead.

Crypto assets may have to be included on a new client intake questionnaire, as the ABA Standards of Tax Practice Committee discussed. Seems coin exchanges are not forthcoming about account holder information in the absence of a court order. Earthman suggested asking more probing questions than do you own this stuff? Clients should be apprised of the danger of losing private keys. Although an adviser cannot assume crypto ownership based on client age, Earthman noted that a quarter of affluent millennials own cryptocurrencies.

More to the point, it is not yet clear to estate planners whether cryptocurrency is tangible or intangible property. Earthman suggested explicitly excluding cryptocurrencies from tangible property in wills and trust documents, lest a USB drive with a valuable private key on it pass with Grandma's flowered china plates. Trust instruments should also specify whether a trustee may retain or invest in cryptocurrencies. If a grantor retains a private key, there may not be a completed gift to a trust (sections 671, 2503).

Nonetheless, Earthman believes that cryptocurrency is tangible property; other lawyers think it is intangible property. There is such a thing as a hard cryptocurrency wallet, and the IRS did seize one. And when Silk Road founder Ross Ulbright's cryptocurrency was seized, the government took his physical computer, she noted.

A lot of holders are trying to make charitable gifts of cryptocurrency — they acquired it cheaply and it is too late to move to Puerto Rico (gains are only exempt if the holder was a resident when the cryptocurrency was acquired). Charitable gifts in excess of $5,000 must have an independent valuation by an experienced appraiser with a history of valuing this particular asset (reg. section 1.170A-13(c)). Those are hard to find for cryptocurrencies. Earthman recommends averaging the daily averages of all the exchanges the cryptocurrency trades on.

FAQ 33 excuses holders who make charitable gifts of cryptocurrency from recognition of gain on the transfer. FAQ 34 states that the amount of the charitable gift deduction is fair market value for crypto capital assets held for a year or longer, and the lesser of basis or FMV for crypto assets held for shorter periods. The general rule is that the contribution deduction is reduced by the short-term capital gain in property (section 170(e)(1)(A)). Thus the government does not express a view whether long-held cryptocurrency is a tangible or intangible asset (section 170(e)(1)(B)).

Is a casualty loss deduction available for a lost private key? Earthman worried that a fiduciary may not be able to prove the existence of a cryptocurrency account a decedent was believed to have. Even when it is discovered, value is so volatile that an executor should elect alternative valuation (section 2032). Nellen explained that lost bitcoin is lost forever; it is not restored to the limited amount of bitcoin to be issued (of which roughly 3 million remain).

WAS THIS ARTICLE HELPFUL? YES

DOCUMENT ATTRIBUTES

CODE SECTIONS	SEC. 1012 BASIS OF PROPERTY- COST
	SEC. 671 TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS
	SEC. 170 CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS
	SEC. 988 TREATMENT OF CERTAIN FOREIGN CURRENCY TRANSACTIONS
JURISDICTIONS	UNITED STATES
SUBJECT AREAS / TAX TOPICS	CRYPTOCURRENCY GAINS AND LOSSES COMPLIANCE
	INFORMATION REPORTING
MAGAZINE CITATION	TAX NOTES FEDERAL, NOV. 4, 2019, P. 709
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Notice 2014-21

SECTION 1. PURPOSE

This notice describes how existing general tax principles apply to transactions using virtual currency. The notice provides this guidance in the form of answers to frequently asked questions.

SECTION 2. BACKGROUND

The Internal Revenue Service (IRS) is aware that "virtual currency" may be used to pay for goods or services, or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. For a more comprehensive description of convertible virtual currencies to date, see Financial Crimes Enforcement Network (FinCEN) *Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (FIN-2013-G001, March 18, 2013).

SECTION 3. SCOPE

In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. This notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term "virtual currency" as used in Section 4 refers only to convertible virtual currency. No inference should be drawn with respect to virtual currencies not described in this notice.

The Treasury Department and the IRS recognize that there may be other questions regarding the tax consequences of virtual currency not addressed in this notice that warrant consideration. Therefore, the Treasury Department and the IRS request comments from the public regarding other types or aspects of virtual currency transactions that should be addressed in future guidance.

Comments should be addressed to:

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2014-21)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered Monday through Friday between the hours of 8 A.M. and 4 P.M. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2014-21)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, taxpayers may submit comments electronically via e-mail to the following address: Notice.Comments@irscounsel.treas.gov. Taxpayers should include "Notice 2014-21" in the subject line. All comments submitted by the public will be available for public inspection and copying in their entirety.

For purposes of the FAQs in this notice, the taxpayer's functional currency is assumed to be the U.S. dollar, the taxpayer is assumed to use the cash receipts and disbursements method of accounting and the taxpayer is assumed not to be under common control with any other party to a transaction.

SECTION 4. FREQUENTLY ASKED QUESTIONS

Q-1: How is virtual currency treated for federal tax purposes?

A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?

A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.

Q-3: Must a taxpayer who receives virtual currency as payment for goods or services include in computing gross income the fair market value of the virtual currency?

A-3: Yes. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency,

measured in U.S. dollars, as of the date that the virtual currency was received. See Publication 525, *Taxable and Nontaxable Income*, for more information on miscellaneous income from exchanges involving property or services.

Q-4: What is the basis of virtual currency received as payment for goods or services in Q&A-3?

A-4: The basis of virtual currency that a taxpayer receives as payment for goods or services in Q&A-3 is the fair market value of the virtual currency in U.S. dollars as of the date of receipt. See Publication 551, *Basis of Assets*, for more information on the computation of basis when property is received for goods or services.

Q-5: How is the fair market value of virtual currency determined?

A-5: For U.S. tax purposes. transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.

Q-6: Does a taxpayer have gain or loss upon an exchange of virtual currency for other property?

A-6: Yes. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. See Publication 544, *Sales and Other Dispositions of Assets*, for information about the tax treatment of sales and exchanges, such as whether a loss is deductible.

Q-7: What type of gain or loss does a taxpayer realize on the sale or exchange of virtual currency?

A-7: The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or

business are examples of property that is not a capital asset. See Publication 544 for more information about capital assets and the character of gain or loss.

Q-8: Does a taxpayer who "mines" virtual currency (for example, uses computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger) realize gross income upon receipt of the virtual currency resulting from those activities?

A-8: Yes, when a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. See Publication 525, *Taxable and Nontaxable Income*, for more information on taxable income.

Q-9: Is an individual who "mines" virtual currency as a trade or business subject to self-employment tax on the income derived from those activities?

A-9: If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax. 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 on to make a profit.

Q-10: Does virtual currency received by an independent contractor for performing services constitute self-employment income?

A-10: Yes. Generally, self-employment income includes all gross income derived by an individual from any trade or business carried on by the individual as other than an employee. Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax. See FS-2007-18, April 2007, *Business or Hobby? Answer Has Implications for Deductions*, for information on determining whether an activity is a business or a hobby.

Q-11: Does virtual currency paid by an employer as remuneration for services constitute wages for employment tax purposes?

A-11: Yes. Generally, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions

Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, *Wage and Tax Statement.* See Publication 15 (Circular E), *Employer's Tax Guide*, for information on the withholding, depositing, reporting, and paying of employment taxes.

Q-12: Is a payment made using virtual currency subject to information reporting?

A-12: A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities, and compensation.

Q-13: Is a person who in the course of a trade or business makes a payment using virtual currency worth $600 or more to an independent contractor for performing services required to file an information return with the IRS?

A-13: Generally, a person who in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, *Miscellaneous Income*. Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in U.S. dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC. See the Instructions to Form 1099-MISC and the General Instructions for Certain Information Returns for more information. For payments to non-U.S. persons, see Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

Q-14: Are payments made using virtual currency subject to backup withholding?

A-14: Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payor must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required. See Publication 1281, *Backup Withholding for Missing and Incorrect Name/TINs,* for more information.

Q-15: Are there IRS information reporting requirements for a person who settles payments made in virtual currency on behalf of merchants that accept virtual currency from their customers?

A-15: Yes, if certain requirements are met. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, *Payment Card and Third Party Network Transactions*, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds $20,000. When completing Boxes 1, 3, and 5a-1 on the Form 1099-K, transactions where the TPSO settles payments made with virtual currency are aggregated with transactions where the TPSO settles payments made with real currency to determine the total amounts to be reported in those boxes. When determining whether the transactions are reportable, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.

See The Third Party Information Reporting Center, http://www.irs.gov/Tax-Professionals/Third-Party-Reporting-Information-Center, for more information on reporting transactions on Form 1099-K.

Q-16: Will taxpayers be subject to penalties for having treated a virtual currency transaction in a manner that is inconsistent with this notice prior to March 25, 2014?

A-16: Taxpayers may be subject to penalties for failure to comply with tax laws. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under section 6721 and 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Keith A. Aqui of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information about income tax issues addressed in this notice, please contact Mr. Aqui at (202) 317-4718; for further information about employment tax issues addressed in this notice, please contact Mr. Neil D. Shepherd at (202) 317- 4774; for further information about information reporting issues addressed in this notice, please contact Ms. Adrienne E. Griffin at (202) 317-6845; and for further information regarding foreign currency issues addressed in this notice, please contact Mr. Raymond J. Stahl at (202) 317- 6938. These are not toll-free calls.

Paul William M

From: Cullinan Thomas A
Sent: Friday, July 12, 2019 7:18 PM
To: Paul William M
Subject: RE: Updated Crypto Rev Rul

Two questions/comments:

(b)(5) Deliberative Process Privilege

[redacted]

From: Paul William M [redacted] (b)(6)
Date: Friday, Jul 12, 2019, 9:57 AM
To: Cullinan Thomas A [redacted] (b)(6)
Subject: FW: Updated Crypto Rev Rul

Paul William M

From: Cullinan Thomas A
Sent: Thursday, June 13, 2019 11:24 PM
To: Paul William M
Subject: Crypto Rev Rul

Hi Bill. I've put my comments below. I did these on the plane with my iPad so sorry about not embedding them in the document. I am going to break them up into a few emails to not risk losing anything.

(b)(5) Deliberative Process Privilege

Paul William M

From: Cullinan Thomas A
Sent: Thursday, June 13, 2019 11:24 PM
To: Paul William M
Subject: Part 2

(b)(5) Deliberative Process Privilege

[redacted]

Paul William M

From: Cullinan Thomas A
Sent: Thursday, June 13, 2019 11:24 PM
To: Paul William M
Subject: Part 3

(b)(5) Deliberative Process Privilege

≡ Investopedia

CRYPTOCURRENCY > CRYPTOCURRENCY STRATEGY & EDUCATION

Virtual Currency

REVIEWED BY JAKE FRANKENFIELD | Updated May 3, 2018

DEFINITION of Virtual Currency

Virtual currency is a type of digital currency that is only available in electronic form and not in physical form. It is stored and transacted in only through designated software, mobile or computer applications, or through dedicated digital wallets, and the transactions occur over the Internet or over secure dedicated networks. Virtual currency is considered to be a subset of the digital currency group, which also includes cryptocurrencies.

BREAKING DOWN Virtual Currency

Virtual currency can be defined as an electronic representation of monetary value that may be issued, managed and controlled by private issuers, developers, or the founding organization. Such virtual currencies are often represented in terms of tokens and may remain unregulated without a legal tender. Unlike regular money, it relies on a system of trust and may not be issued by a central bank or other banking regulatory authority. Due to the lack of a centralized regulatory authority, such virtual currencies are prone to wide swings in their valuations. They derive their value based on the underlying mechanism, like mining in cases of cryptocurrencies, or the backing by the underlying asset.

The term came into existence around 2012, when the European Central Bank (ECB) defined virtual currency to classify types of "digital money in an unregulated environment, issued and controlled by its developers and used as a payment method among members of a specific virtual community," according to Bitcoins News.

Along with use by the common public, a virtual currency can have restricted usage, and it may be in circulation only among the members of a specific online community or a virtual group of users who transact online on dedicated networks. Virtual currencies are mostly used for peer-to-peer payments and are finding increasing use for purchase of goods and services.

Difference between Digital, Virtual, and Crypto Currencies

Digital currency is the overall superset that includes virtual currency, which in turn includes cryptocurrencies.

Compared to a virtual currency, a digital currency covers a larger group that represents monetary assets in digital form. Digital currency can be regulated or unregulated. In the former case, it can be denominated to a sovereign currency – that is, a country's central bank can issue a digital form of its fiat currency notes. On the other hand, a virtual currency often remains unregulated and hence constitutes a type of digital currency.

Cryptocurrencies like Bitcoin and Ethereum are considered to be a part of the virtual currency group. A cryptocurrency uses cryptography technology that keeps the transactions secure and authentic, and also helps to manage and control the creation of new currency units. Such cryptocurrencies exist and are transacted over dedicated blockchain based networks which are open to the common public. Anyone can join and start transacting in cryptocurrencies. (See also, *How Bitcoin Works*?)

Paul William M

To: Moriarty John P; Wrobel Christopher
Cc: Cullinan Thomas A
Subject: Interesting Piece on how Libra will be taxed

How will Libra be taxed?

Dante Disparte of Libra: Taxing of digital assets is something that's being designed at the local level and at the jurisdiction level. Our view of the world is that like with any form of money or any form of payment or banking, the onus in terms of compliance with tax is with the individual user and consumer, and the same would hold true broadly here.

We expect that the many, many wallets and financial services providers building solutions on the Libra blockchain would begin to provide tools that make it much easier than it is today [to calculate and file taxes] for digital assets and cryptocurrencies more generally . . . There's plenty of time between now and Libra hitting the market to begin defining this more strictly at the jurisdictional level among providers.

TechCrunch's Analysis: Again, here Facebook, Calibra and the Libra Association are hoping to avoid shouldering all the responsibility for taxes. Their position is that just as you have to take the initiative of paying your taxes whether or not you use a Visa card or your bank's checks to transact, it's on you to pay your Libra taxes.

TechCrunch: Do you think in the United States that it's reasonable for the government to ask that Libra transactions be taxed?

Disparte: Tax treatments of digital assets broadly hasn't been entirely clarified in most places around the world. And we hope that this is something that this project and the ecosystem around it helps to clarify.

Tax authorities will see a benefit from Libra at the consumption level and at the household level, while some cryptocurrencies have avoided taxes until the point they tried to cash out. But the nature of it and the lack of speculation and its design we think should give it a light tax treatment the way you would find with traditional currencies.

Christian Catalini of Facebook: Cryptocurrencies are taxed right now every time you have a sale on the differences in gains and losses. Because Libra is designed to be a medium of exchange, those gains and losses are likely to be very tiny relative to your local currency . . . Sales tax would likely be implemented the exact same way on Libra as it is today when you pay with a credit card.

At launch giving current regulations, the Calibra wallet will have to track every purchase and sale of Libra for a U S. user and those differences will have to be reported on tax day. You can think of the losses, albeit they may be very small gains and losses relative to USD, as similar to the what people do today when they have a Coinbase account with Bitcoin.

The sales tax I think could be implemented in the exact same way as it today with any other sort of digital payment, it would be no different. If you're buying goods or services with Libra you'll be paying sales tax the same way as if you used a different form of payment. Like today when you see a percentage, that is the sales tax on your total.

Disparte: Maybe the best way to frame how taxes work all over the world is that it's not up to Libra, Calibra, Facebook or any company to make that determination. It's up to regulators and authorities.

TechCrunch: Does Calibra already have plans in place for how to handle sales tax?

Weil: That's also a pretty rapidly evolving part of the regulatory ecosystem right now. It's really an ongoing discussion. We will do whatever the regulation says we need to do.

TechCrunch's Analysis: Here we have the firmest answers of our interviews. Facebook, Calibra and the Libra Association believe the proper approach to taxes is that Libra transactions carry a country's traditional sales tax, and that Libra you hold in your wallet will have to pay taxes based on the Libra stablecoin's value (that's pegged to a basket of international currencies) relative to the U.S. dollar.

If the Libra Association recommends all wallets and transactions follow these rules and Calibra builds in protocols to handle these taxes simply, at least the government can't argue Libra is a method of dodging taxes and everyone paying their fair share.

Paul William M

From: Stahl Raymond J
Sent: Tuesday, July 16, 2019 6:20 PM
To: Paul William M
Cc: Blessing Peter H; McCall Daniel M; Marra Anthony J; Abramoff Azeka J
Subject: FW: 988 question
Attachments: Virtual currency outline 2-7-14 (3).docx; TNT.pdf

Bill,

Dan shared your questions about virtual currency and section 988. The following email summarizes our views on those questions. Please let us know if you have any questions or if it would be helpful to discuss this.

(b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

[redacted]

Best wishes,
Ray

From: McCall Daniel M
Sent: Tuesday, July 16, 2019 3:28 PM
To: Stahl Raymond J; Marra Anthony J
Subject: FW: 988 question

From: Paul William M [redacted] (b)(6)
Date: Tuesday, Jul 16, 2019, 1:49 PM
To: McCall Daniel M [redacted] (b)(6)
Subject: RE: 988 question

Dan,

(b)(5) Deliberative Process Privilege

[redacted]

Thanks.

From: McCall Daniel M
Sent: Tuesday, July 16, 2019 11:59 AM
To: Paul William M
Subject: RE: 988 question

Hi Bill,

Will do.
Dan

From: Paul William M <[redacted] (b)(6)
Date: Tuesday, Jul 16, 2019, 11:25 AM
To: McCall Daniel M [redacted] (b)(6)
Subject: 988 question

Dan,

(b)(5) Deliberative Process Privilege

[redacted]

Thanks.

Bill

Department of the Treasury
Internal Revenue Service
[Operating Division / Program Name]
[Street address]
[City, State ZIP]

Date:
07/18/2019
Taxpayer ID number:

Hotline telephone number:

Tax form:
Form 1040

[Recipient name]
[Address line 1]
[Address line 2]
[Address line 3]

Reporting Virtual Currency Transactions

Dear [Name]:

Why we're writing to you
We have information that you have or had one or more accounts containing virtual currency but may not know the requirements for reporting transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

What you need to do
After reviewing the information below, if you believe you didn't accurately report your virtual currency transactions on a federal income tax return, you should file amended returns or delinquent returns if you didn't file a return for one or more taxable years. If you do not accurately report your virtual currency transactions, you may be subject to future civil and criminal enforcement activity. For more information, visit www.irs.gov/filing.

When filing amended or delinquent returns, write "Letter 6174" at the top of the first page of the return. Mail the original amended or delinquent return to:

Internal Revenue Service
2970 Market Street
Philadelphia, PA 19104

Reporting virtual currency transactions
Virtual currency is considered property for federal income tax purposes. Generally, U.S. taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the U.S. or abroad. More information can be found on www.irs.gov and in Notice 2014-21, found at www.irs.gov/pub/irs-drop/n-14-21.pdf, which describes how general tax principles for property transactions apply to transactions involving virtual currency.

You must report virtual currency transactions on your return, regardless of whether you received a payee statement for the transaction (such as a Form W-2, Form 1099, etc.).

Common schedules for reporting virtual currency transactions include the following:

Schedule C
If you were an independent contractor and received payment in virtual currency, you must report it in gross income for the amount of the virtual currency's fair market value, measured in U.S. dollars, as of the date and time you received the virtual currency. Gross income derived by an individual from a trade or business, carried on by the individual as other than an employee, is reported on Schedule C. This constitutes self-employment income and is subject to the self-employment tax.

For more information, you can refer to the instructions for Schedule C.

Schedule D
If you sold, exchanged, or disposed of virtual currency (e.g. Bitcoin, Ether), or used it to pay for goods or services, you have engaged in a reportable transaction and may have a tax liability. These transactions may be reportable on Schedule D. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You should maintain and review all transaction records, including bank, wallet, and exchange reports and statements to determine your basis, amount received, and other information needed for reporting on Schedule D.

For more information, you can refer to the instructions for Schedule D.

Schedule E
If you received supplemental income in the form of virtual currency, including income from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in REMICs, you may need to report this on Schedule E. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You may also need to file supplemental forms (e.g. Form 8582, Passive Activity Loss Limitations). See the instructions for Schedule E for any other circumstances that may apply.

For more information, you can refer to the instructions for Schedule E.

Additional Resources

- Publication 17, Your Federal Income Tax (For Individuals)
- Instructions for Form 1040, U.S. Individual Income Tax Return
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- Instructions for Form 1120-S, U.S. Income Tax Return for an S Corporation
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You can get the forms, instructions, and publications mentioned in this letter by visiting our website at www.irs.gov/forms-pubs or by calling 800-TAX-FORM (800-829-3676).

You do not need to respond to this letter.

If you have questions, you can call the hotline telephone number shown at the top of this letter and leave a message. We'll respond to all messages within three business days.

Thank you for your cooperation.

Sincerely,

[Name]
[Title]

Department of the Treasury
Internal Revenue Service
[Operating Division / Program Name]
[Street address]
[City, State ZIP]

Date:
07/18/2019
Taxpayer ID number:

Hotline telephone number:

Tax form:
Form 1040

[Recipient name]
[Address line 1]
[Address line 2]
[Address line 3]

Reporting Virtual Currency Transactions

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Philadelphia, PA 19104

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Sincerely,

[Name]
[Title]

Department of the Treasury
Internal Revenue Service
[Program or Division Name]
[Street address]
[City, State ZIP]

Date:

Taxpayer ID number:

Hotline telephone number:

Tax form:
Form 1040

[Recipient name]
[Address line 1]
[Address line 2]
[Address line 3]

Reporting Virtual Currency Transactions

Dear [Name]:

Why we're writing to you
We have information that you have or had one or more accounts containing virtual currency but may not have properly reported your transactions involving virtual currency, which include your cryptocurrency as well as other non-crypto virtual currencies.

What you need to do
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Thank you for your cooperation.

Sincerely,

[Name]
[Title]

Paul William M

From: Blessing Peter H
Sent: Tuesday, July 16, 2019 6:48 PM
To: Zuba Kathryn A; Desmond Michael J
Cc: Paul William M; Tonuzi Drita; Cullinan Thomas A
Subject: RE: Crypto Guidance

[redacted] (b)(6) we will instead work other sources including one of our folks who participated in the OECD crypto working party.

From: [redacted] (b)(6)
Date: Tuesday, Jul 16, 2019, 6:46 PM
To: Zuba Kathryn A <[redacted] (b)(6)>, Desmond Michael J <[redacted] (b)(6)>
Cc: Paul William M <[redacted] (b)(6)> Tonuzi Drita [redacted] (b)(6), Cullinan Thomas A <[redacted] (b)(6)>
Subject: RE: Crypto Guidance

We think it's Nancy Lee and are waiting for her to revert. She is in detail to LBI.

From: Zuba Kathryn A [redacted] (b)(6)
Date: Tuesday, Jul 16, 2019, 6:44 PM
To: Desmond Michael J <[redacted] (b)(6)>, Blessing Peter H [redacted] (b)(6)
Cc: Paul William M <[redacted] (b)(6)>, Tonuzi Drita <[redacted] (b)(6)>, Cullinan Thomas A <[redacted] (b)(6)>
Subject: RE: Crypto Guidance

Mike,
I'm not, but Amy Guiliano tells me an attorney in International is following the developments on FBAR. I'll find her name for Peter tomorrow when the PA person assigned to the crypto cadre gets in.

Kathy

From: Desmond Michael J
Sent: Tuesday, July 16, 2019 6:30 PM
To: Zuba Kathryn A; Blessing Peter H
Cc: Paul William M; Tonuzi Drita; Cullinan Thomas A
Subject: Crypto Guidance

Kathy and Peter,

Following up on the Treasury bi-weekly this afternoon and Dave Kauter's ask for a list of all crypto-related guidance under consideration at the IRS, are either of you aware of coordination with other parts of Treasury on FBAR or FATCA reporting for crypto?

LB&I mentioned both on a call this morning, indicating that FinCen's published position on no FBAR reporting is based on the IRS' treatment of crypto as property. I was aware of that but have not heard anything about FATCA.

AICPA®

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

June 10, 2016

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2014-21)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on Notice 2014-21: Virtual Currency Guidance

Dear Sir or Madam:

The American Institute of CPAs (AICPA) submits the following comments in response to the Internal Revenue Service (IRS) guidance on how existing general tax principles apply to transactions using virtual currency. The recommendations included in this letter were developed by the AICPA Individual & Self Employed Tax Technical Resource Panel (TRP) and approved by the AICPA Tax Executive Committee.

We applaud the IRS for working expeditiously to release guidance in the form of answers to frequently asked questions (FAQs) regarding the tax treatment of virtual currency transactions, an area that has quickly grown and become a prevalent concern for many taxpayers and tax practitioners. However, we recognize there are a few major issues, not addressed in Notice 2014-21, that may arise as virtual currency continues to expand and gain additional popularity in the marketplace.

The AICPA encourages the IRS to release additional, much needed, guidance on virtual currency. Specifically, we request further guidance on the following items:

1. **<u>Acceptable Valuation and Documentation</u>**

   Issue further guidance and provide examples to better define "reasonable manner," as described in Section 4, Q&A-5 of Notice 2014-21.

   Q&A-5 refers to exchange rates established by market supply and demand. It also states that taxpayers are recommended to use a "reasonable manner that is consistently applied" to calculate the fair market value of virtual currency. In regards to this issue, please provide additional details on the following questions:

a. Are taxpayers required to select one exchange and continue to use this same exchange?
b. Are taxpayers allowed to use an average of different exchanges?
c. May taxpayers use the average rate for the day to calculate the exchange rate or is there a specific time during the day to pull exchange rates?

With respect to bitcoin, there are a few published exchanges and the value reported on each exchange at any time of the day is unlikely the same.

For example, these bitcoin values were pulled on January 31, 2015 at 8:25 am (Eastern Time):

• Google	$231.1462
• Bitcoin exchange rate	$229.80
• Bitstamp	$228.24
• CEX	$231
• Winkdex	$227.94

These values were pulled on May 20, 2015 at 10:20 am (Eastern Time):

• Google	$234.2500
• Bitcoin exchange rate	$234.21
• Bitstamp	$233.67
• CEX	$231
• Winkdex	$232.29

2. Expenses of Obtaining Virtual Currency

Provide guidance on the treatment of the costs of mining and acquiring virtual currency. This guidance should also address when, if ever, any costs of acquiring virtual currency is capitalized.

Generally, the costs of acquiring property are treated as part of the basis of that property. Section 4, Q&A-8 of Notice 2014-21 states that when virtual currency is mined, gross income is realized upon receipt at fair market value. This language implies that mining is akin to a service activity, rather than a production activity where income is not realized until disposition of the property. Therefore, it seems the costs of mining virtual currency are treated similarly to expenses incurred in providing other services; i.e., expensed as paid or incurred.

3. **Challenges with Specific Identification for Computing Gains and Losses**

Allow an alternative treatment under section 1012[1] (e.g., first in first out (FIFO)).

The treatment of convertible virtual currency as non-cash property means that any time virtual currency is used to acquire goods or services, a barter transaction takes place, and the parties need to know the fair market value (FMV) of the currency on that day. The party exchanging the virtual currency for the goods or services will need to also track the basis of all of his or her currency to determine if a gain or loss has occurred and whether it is a short-term or long-term transaction. This determination involves a significant amount of recordkeeping, even if the transaction is valued at under $10.

Currently, there are no alternative tracking methods provided for such transactions (other than for securities under Treas. Reg. § 1.1012-1(c)). Therefore, taxpayers are required to specifically identify which virtual currency lot was used for each transaction in order to properly determine the gain or loss for that particular transaction. In many cases, it is impossible for a taxpayer to track which specific virtual currency was used for a particular transaction.

4. **General Guidance Regarding Property Transactions Rules**

If the IRS believes any property transaction rules should apply differently to virtual currency than to other types of property, taxpayers will need additional guidance in order to properly distinguish the rules and regulations.

Section 4, Q&A-1 of Notice 2014-21 states that "general tax principles applicable to property transactions apply to transactions using virtual currency," which is guidance that is generally helpful in determining the tax consequences of most virtual currency transactions. However, if there are particular factors that distinguish one virtual currency as like-kind to another virtual currency for section 1031 purposes, the IRS should clarify these details (e.g., allowing the treatment of virtual currency held for investment or business as like-kind to another virtual currency) in the form of published guidance. Similarly, taxpayers need specific guidance of special rules or statutory interpretations if the IRS determines that the installment method of section 453 is applied differently for virtual currency than for other types of property.

5. **Nature of Virtual Currency Held by a Merchant**

Provide guidance as to whether virtual currency held by a merchant is a capital or ordinary asset.

[1] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder, unless otherwise specified.

A merchant may hold virtual currency for use in paying employees and suppliers. In this capacity, the virtual currency is used in the form of U.S. currency. However, due to the treatment of this currency as property, and the gain or loss that results each time a virtual currency is used, the character of this specific type of currency asset is an important determination.

6. Charitable Contributions

Provide guidance to explain when a donation of virtual currency, valued above $5,000, does not need a qualified appraisal to substantiate a charitable contribution deduction. Additionally, provide guidance on how to document the virtual donation values.

A charitable contribution of property with a value in excess of $5,000 requires a qualified appraisal from a qualified appraiser. An exception exists for contributions of publicly traded stock. The rationale is that the prices of these publicly traded stocks are available on published exchanges, thus not requiring a qualified appraisal. The same is true for most, if not all, types of virtual currency. That is, an exchange publishes the values of this currency on any given day. Therefore, a similar exception should apply for virtual currency donations in excess of a certain amount.

7. Virtual Currency as a "Commodity"

Provide guidance on whether virtual currency is considered a "commodity" subject to mark-to-market accounting under sections 475(e) and 475(f).

This particular issue is also under consideration by the Commodity Futures Trading Commission.[2]

8. Need for a De *Minimis* Election

Currently, section 988(e)(2) allows for an exclusion of up to $200 per transaction for foreign currency exchange rate gain, if derived from a personal transaction. Can a similar rule apply for virtual currency transactions even though they are taxed as property (rather than as a currency)?

Some taxpayers may only have a minimal amount of virtual currency that is designated for making small purchases (such as buying coffee). Tracking the basis and FMV of

[2] Testimony of Commissioner Mark Wetjen before the U.S. House Committee on Agriculture Subcommittee on Commodity Exchanges, Energy, and Credit Subcommittee, April 14, 2015; http://www.cftc.gov/PressRoom/SpeechesTestimony/opawetjen-12. Also see Nermin Hajdarbegovic, "Commissioner Claims CFTC Can Intervene in Bitcoin Markets," CoinDesk, Nov. 18, 2014; http://www.coindesk.com/commissioner-claims-cftc-can-intervene-bitcoin-markets/

the virtual currency for each of these small purchases is time consuming, burdensome, and will yield a de *minimis* amount of gain or loss. A binding election applicable for a specified amount of virtual currency owned or classified for personal purposes is beneficial to taxpayers.[3]

9. Retirement Accounts

Provide guidance on whether retirement savings accounts are permitted to hold virtual currency investments. If yes, explain any special reporting rules or other requirements that exist if a retirement account contains this type of virtual property.

10. Foreign Reporting Requirements for Virtual Currency

Provide guidance on whether virtual currency accounts can become reportable on the Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR) in future tax years. Also, explain whether there are circumstances that can alter virtual currency accounts into foreign financial assets under section 6038D, and therefore required for reporting on Form 8938, *Statement of Specified Foreign Financial Assets*.

Also, provide guidance on whether additional reporting obligations exist under the Foreign Account Tax Compliance Act (FATCA) or whether there are other requirements for money services businesses (MSB) that exchange virtual currency. For example, would the IRS consider this exchange a financial institution activity?

Taxpayers do not have guidance on how virtual currency rules will change for future tax years. An IRS analyst for the Small Business/Self-Employed Division stated,[4] in June of 2014, that virtual currency accounts were not reportable on the Form 114, *Report of Foreign Bank and Financial Accounts*, for tax years ended 2014. However, no guidance was provided in regards to future tax years. Virtual currencies are intangible assets because they are represented by a code. These currencies, such as Bitcoin, operate in decentralized environments where no entity or person is in charge of controlling or monitoring the asset. Therefore, the currency appears to have no location, which is a characteristic that would complicate foreign reporting compliance.

* * * * *

[3] If it is determined that statutory action is needed to enact such a rule, we encourage the IRS to reach out to Congress for this request.

[4] Rod Lundquist, a senior program analyst for the Small Business/Self-Employed Division, stated in a webcast that, for FBAR purposes, Bitcoin is not reportable "...not at this time." Lundquist also stated that "FinCEN has said that virtually currency is not going to be reportable on the FBAR, at least for this filing season," broadcasted June 4, 2014, see archived webcast: http://www.irsvideos.gov/ElectronicFBAR/.

Virtual currency transactions, in which taxpayers increasingly engage, add a new layer of complexity to the analysis of a client's reporting requirements. The issuance of clear guidance in this area will not only reduce the confusion and burden for tax preparers but also allow taxpayers to accurately comply with IRS rules

The AICPA is the world's largest member association representing the accounting profession, with more than 412,000 members in 144 countries, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our concerns and recommendations and welcome the opportunity to discuss these items further. If you have any questions, please feel free to contact me at (801) 523-1051, or tlewis@sisna.com; or you may contact Kenneth Rubin, Chair, AICPA Individual & Self-Employed Tax Technical Resource Panel, at (314) 290-3417, or ken.rubin@rubinbrown.com; or Amy Wang, AICPA Senior Technical Manager, at (202) 434-9264, or awang@aicpa.org.

Sincerely,

Troy K. Lewis

Troy K. Lewis, CPA, CGMA
Chair, AICPA Tax Executive Committee

cc: The Honorable John A. Koskinen, Commissioner, Internal Revenue Service
The Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service
Mr. Thomas C. West, Jr., Tax Legislative Counsel, Department of the Treasury

Defending Liberty
Pursuing Justice

TAXATION
A Section of the American Bar Association

Section of Taxation

Suite 400
1050 Connecticut Avenue, NW
Washington, DC 20036
202-662-8670
FAX: 202-662-8682
E-mail: tax@americanbar.org

March 19, 2018

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017

Dear Acting Commissioner Kautter:

Enclosed please find comments regarding the federal income tax treatment of cryptocurrency hard forks that have taken place in 2017 ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: Hon. William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Tax Legislative Counsel, Department of the Treasury
Rochelle Hodes, Associate Tax Legislative Counsel, Department of the Treasury
Drita Tonuzi, Deputy Chief Counsel (Operations), Internal Revenue Service
Scott Dinwiddie, Associate Chief Counsel (IT&A), Internal Revenue Service
Donna Welsh, Senior Technician Reviewer (IT&A, Branch 4), Internal Revenue Service
Kathryn Zuba, Associate Chief Counsel (PA), Internal Revenue Service
Helen Hubbard, Associate Chief Counsel (FIP), Internal Revenue Service
Karl Walli, Senior Counsel (Financial Products), Department of the Treasury

American Bar Association
Section of Taxation
Comments on the Tax Treatment of Hard Forks

The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Omri Marian, Vice Chair of the Section's Teaching Taxation Committee (the "Committee"), and Kerry Ryan, Chair of the Committee, had the principal responsibility for preparing these Comments. Substantive contributions were made by Adam Chodorow, James Creech, Elizabeth Crouse, Diane Ring, and Lisa Zarlenga. The Comments were reviewed by Lisa Zarlenga, Chair of the Section's Committee on Government Submissions.

Although some of the members of the Section who participated in preparing these Comments have clients who may be affected by the federal income tax principles addressed herein, no such member, or the firm or organization to which such member belongs, has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Omri Marian
(949) 824-6493
omarian@law.uci.edu

Kerry A. Ryan
(314) 977-7273
kerry.ryan@slu.edu

Date: March 19, 2018

Executive Summary

In 2014, the Internal Revenue Service (the "Service") issued Notice 2014-21 (the "2014 Notice"),[1] addressing the federal income tax treatment of "virtual currencies." The Section offered comments to the 2014 Notice in a letter dated March 24, 2015.[2] Since then, several important developments in the cryptocurrency[3] economy have taken place that are not addressed in the 2014 Notice. These developments raise important federal income tax questions, and we appreciate the opportunity to respond to the Service's request for comments on these issues.

An important issue, and the focus of these Comments, is the proper federal income tax treatment of a cryptocurrency hard fork ("Hard Fork"). A Hard Fork is a "change to the software of the digital currency that creates two separate versions of the blockchain with a shared history."[4] After a Hard Fork takes place, the original owner of the cryptocurrency retains its interest in the original coin and also has the right to use the forked coin. Hard Forks raise unique tax issues. Specifically, does a holder of a cryptocurrency that experiences a Hard Fork realize income for federal income tax purposes? If so, how much and when? The significant volatility in the exchange prices of cryptocurrency make valuation difficult and inconsistent among taxpayers.

As discussed further in these Comments, current law provides no clear answers to these questions. There are reasonable analogies to both taxable and nontaxable events. In light of the legal ambiguity, the significant valuation issues, and need for immediate guidance regarding the 2017 Hard Forks, the Section recommends that the Service consider issuing guidance that offers a temporary rule, in the form of a safe-harbor, to taxpayers who were able to transact in a forked currency as a result of a Hard Fork during the 2017 tax year. We recommend that such guidance prescribe the following:

1. Taxpayers who owned a coin that was subject to a Hard Fork in 2017 would be treated as having realized the forked coin resulting from the Hard Fork in a taxable event.

2. The deemed value of the forked coin at the time of the realization event would be zero, which would also be the taxpayer's basis in the forked coin.

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[1] Notice 2014-21, 2014-16 I.R.B 938.

[2] https://www.americanbar.org/content/dam/aba administrative/taxation/policy-032415comments.authcheckdam.pdf.

[3] These Comments also refer to virtual currency as "digital currency," "cryptocurrency," or "coins."

[4] David Farmer, *What is a Bitcoin fork?*, THE COINBASE BLOG (Jul. 27, 2017), https://blog.coinbase.com/what-is-a-bitcoin-fork-cba07fe73ef1.

3. The holding period in the forked coin would start on the day of the Hard Fork.

4. Taxpayers choosing the safe harbor treatment as set forth in the guidance would be required to disclose this on their tax returns.[5]

5. The Service would not assert that any taxpayer who availed themselves of the safe harbor treatment as set forth in the guidance has understated federal tax liability because of the receipt of a forked coin in a 2017 Hard Fork.

6. The Service, with input from the Section and other stakeholders, will continue to develop its position regarding the tax treatment for future Hard Forks, and such position may be different from the one noted above and will apply prospectively.

This temporary rule has the benefit of encouraging consistency among taxpayers with respect to 2017 Hard Forks, avoiding difficult timing and valuation issues (including the ability of taxpayers to benefit from hindsight depending on how the values fluctuated during 2017), and providing information to the Service regarding holders of the original and forked cryptocurrencies. Although the treatment may result in capital gain as opposed to ordinary income treatment, it preserves the full value of the forked coin for taxation when the taxpayer sells it. In addition, it restarts the holding period, thus resulting in sales occurring within a year being taxed as short-term capital gains.

The Section will continue to develop its position on the tax treatment of future Hard Forks and is considering other issues for comment in the cryptocurrency area. The Section looks forward to working with the Service on these issues.

[5] The guidance could provide for a simplified disclosure procedure for taxpayers who may already have filed a 2017 return, but who otherwise have taken a position consistent with the guidance with respect to Hard Forks.

I. Hard Forks in General

Cryptocurrencies are digital tokens, the ownership of which is recorded on a decentralized ledger. Cryptocurrencies are held in "wallets," which may be a type of hardware (*e.g.*, a device similar to a USB drive) or a type of software. Hardware wallets must be physically available to access certain security keys stored on the hardware that are required to control the disposition of the relevant cryptocurrency. Software wallets are just that: software stores the security keys that are required to control the disposition of the relevant cryptocurrency. Software wallets may be hosted in a variety of ways, including on the cloud, a desktop computer, or a mobile phone.

The security keys necessary to transfer cryptocurrency consist of a public key and a private key. Both are large strings of numbers that are mathematically linked to the wallet address. The private key is used to generate a "signature" for each blockchain transaction a user sends out. The private key is used to mathematically derive the public key, which is transformed with a hash function to produce the address that other people can see.

Cryptocurrencies generally may be traded for other cryptocurrencies or fiat currencies, for example the U.S. dollar, on exchanges that function much like stock exchanges. Cryptocurrency exchanges may also provide a software wallet in which users can store security keys for relevant cryptocurrencies. Trading on these platforms occurs in a manner analogous to trading in "street name" when an owner has an account with a large brokerage. That is, the exchange controls the owner's security keys and conducts batch trades for multiple users. This is a high-level description of how some intermediaries operate, though there are numerous variations.

Because the software that runs the ledger generally is open-source, and the network of computers that verify transactions generally operates via consensus, the software can be modified if enough participants on the network agree to do so. Hard Forks, sometimes also known as "Chain Splits" or "Coin Splits," are one example of such modifications. When a Hard Fork occurs, a new "branch" splits from the original ledger and is thereafter separately maintained. This means that the network of computers separates into subgroups, which separately verify transactions on the original ledger and the split or forked ledger. Those people whose ownership of a cryptocurrency was recorded on the original ledger maintain their ownership of the original cryptocurrency, but they are also entitled to claim ownership of the cryptocurrency maintained on the forked ledger. When an owner holds a cryptocurrency wallet directly (rather than through a custodial wallet), the owner does not actually receive anything new in a Hard Fork. Instead, the owner—once he or she has taken the necessary steps (as described below)—is able to use the same private key to transact on each of the ledgers. If the owner uses his or her private key to transact in the original cryptocurrency, the network participants verifying transactions on the original ledger will add it to that ledger, but the network participants verifying transactions on the forked ledger will not recognize it. This enables the owner to use his or her private key separately to transact in the forked coin and the original coin. The ownership history of both the original and forked cryptocurrency trace back to the same block on the blockchain, but going forward, the ledger of each cryptocurrency is independent (*i.e.*, they are not interchangeable).

It may be helpful to compare Hard Forks with "soft forks," which are more similar to a software upgrade. In a soft fork, the same blockchain is maintained (there is no split or branching), but some changes to the related software are made such that the blockchain functions somewhat differently after the soft fork. By analogy, a soft fork is more similar to the release of a new version of an existing variety of word processing software, for example, Microsoft Word. The new version typically recognizes documents created using the original version, but the original version may not recognize documents created using the new version unless the original software is updated.

There are many reasons for network participants to agree to Hard Forks. For example, one reason for Hard Forks is that users of the network agree that a fundamental upgrade to the ledger software is required. For example, on August 1, 2017, Bitcoin split into bitcoin (BTC) and bitcoin cash (BCH).[6] The purpose in creating BCH was to allow for a quicker generation of forked coins, as well as other improvements. Nonetheless, both BCH and BTC remain in existence, and both enjoy considerable trust of the cryptocurrency community. In contrast, some forks are a response to user mistrust in the original coin. For example, in 2016, the Ethereum blockchain was split into two in response to a hacking attack that affected the original ledger. In that case, the value of the original coin (Classic Ethereum) and the volume of trading in it plummeted due to the loss of user trust, while the forked coin (Ethereum), which is viewed more favorably by the market, essentially usurped the original coin. Even though original owners of Ethereum owned both the original and forked coins on the day of the split, the original coins became nearly worthless in comparison on that day (though both still trade and the original coin has since reached a greater price than it had prior to the fork).

In the case of a Hard Fork, an owner of the original coin must take active steps in order to transact in the forked coin. An owner that holds the original coin in a basic wallet (whether hardware or software), generally must download new software to a computer to use the forked coin. This requires some level of technological sophistication

[6] Other examples of Bitcoin chain splits include bitcoin gold in October 2017, bitcoin diamond in November 2017, and superbitcoin, bitcoin hot, and lightning bitcoin in December 2017.

and is inconvenient, but is not unduly burdensome for a reasonably experienced computer user. An owner that holds the original coin through certain other types of wallets is not required to download the software because the wallet service provider downloads the software, thus "supporting" the forked coin created in the Hard Fork. This is much easier for the average owner, but means that owners who use a custodial wallet service depend on the wallet service provider to permit them access to the forked coin.

For example, a few days before the BCH Hard Fork, Coinbase sent an e-mail to its customers stating that Coinbase has "no plans to support the Bitcoin Cash fork… Customers will not have access to, or be able to withdraw, bitcoin cash."[7] Only three days after the Hard Fork happened, Coinbase announced that it would support BCH, and would credit their customers' accounts accordingly.[8] Similarly, Xapo announced that customers had until December 14, 2017 to transfer or convert their BCH to BTC, or they would automatically convert it.[9] Many owners and wallet service providers take no action to claim the forked currency until the security risks have been sufficiently evaluated and mitigated. Nonetheless, it is generally possible for an owner to transfer the original coin from one wallet that will not support a Hard Fork and into another wallet that will support the Hard Fork prior to the occurrence of the Hard Fork. In that manner, the owner generally should be able to go through the processes necessary to claim the forked coin, at least if the owner is aware that a Hard Fork is going to occur.

II. Potential Tax Treatments of Hard Forks

Hard Forks raise the question of whether owners of an original coin who become entitled to use a forked coin by reason of a Hard Fork, realize income. We believe reasonable arguments may be made both ways because Hard Forks may be analogized to existing taxable and nontaxable events.

A. Hard Fork as a Realization Event

The Supreme Court in *Commissioner v. Glenshaw Glass*[10] liberally construed the term "gross income" as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion," reflecting Congress' intent to tax

[7] David Farmer, *Update for customers with bitcoin stored on Coinbase*, THE COINBASE BLOG (Jul. 27, 2017), https://blog.coinbase.com/update-for-customers-with-bitcoin-stored-on-coinbase-99e2d4790a53.

[8] David Farmer, *Update of Bitcoin Cash*, THE COINBASE BLOG (Aug. 3, 2017), https://blog.coinbase.com/update-on-bitcoin-cash-8a67a7e8dbdf.

[9] Xapo Bitcoin Cash Update, https://support.xapo.com/xapo-bitcoin-cash-update.

[10] 348 U.S. 426, 431 (1955).

all gains except those specifically exempted. One could argue that the ability to use the forked coin in addition to the original coin represents such an accession to wealth.

In *Eisner v. Macomber*, the Supreme Court considered whether a pro-rata stock dividend paid to a common shareholder by a corporation with one class of stock constituted income. In holding that it did not, the Court distinguished taxable "gain derived from capital" from unrealized—and therefore nontaxable—"gain accruing to capital or a growth or increment of value in the investment."[11] The pro-rata stock dividend in *Macomber* fell into the latter category because it was simply an additional piece of paper evidencing the increased worth of the taxpayer's original investment in the company—the shareholder has received nothing out of the corporation's assets for his use and benefit, and the corporation has not experienced a change in its aggregate assets or its outstanding liabilities.[12] In contrast, the Court defined a taxable "gain derived from capital" as "something of exchangeable value proceeding from the property, severed from the capital . . . and received or drawn by the [taxpayer] for his separate use, benefit and disposal."[13]

In *Macomber*, the receipt of additional stock was a consequence of owning the original stock, and the same could be said for forked coins, such as BCH, received in a Hard Fork. However, unlike in *Macomber*, BCH has unique properties, and it is unrelated to BTC except by the shared historical ownership. Thus, unlike the taxpayer in *Macomber*, one could argue that an owner of BTC who received BCH at the time of the fork received a new and different asset of exchangeable value for the owner's separate use rather than something representing an increase in the underlying value of the previously held BTC.

The regulations under section 1001[14] define a realized gain or loss as, *inter alia*, one from "the exchange of property for other property differing materially in either kind or extent."[15] The Supreme Court in *Cottage Savings Association v. Commissioner* defined materially different properties as those where "their respective possessors enjoy legal entitlements that are different in kind or extent."[16] Although there was not an exchange of BTC for BCH at the time of the Hard Fork, such that *Cottage Savings* is not precisely on point, the definition is useful in determining whether a holder of BTC at the

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[11] 252 U.S. 189, 207 (1920). This case involved a number of Constitutional issues that are not relevant here. Rather, we cite the case for the proposition that realization is an important element of income.

[12] *Id.* at 210-11.

[13] *Id.* at 207.

[14] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

[15] Reg. § 1.1001-1(a).

[16] 499 U.S. 554, 555 (1991).

Hard Fork received something materially different than the previously held BTC. One might argue that the upgrade reflected in the forked cryptocurrency represents a significant change in the protocol that mattered to users (otherwise the fork would not have been permanent), thus representing a material change. Although the forked cryptocurrencies share a pre-split transaction history, a Hard Fork represents a permanent split in the blockchain. Thereafter, transactions on the original blockchain are valid only in BTC, but invalid in BCH, and vice versa. In addition, BTC and BCH are traded separately, each with its own value.

Based on the above authorities, we believe a reasonable argument can be made that the receipt of a forked coin resulting from a Hard Fork constitutes a realization event.[17] However, even if one accepts such a view, there remains ambiguity as to *when* the realization occurs, and what is the *amount* realized.

Timing of realization

As mentioned above, the Supreme Court in *Commissioner v. Glenshaw Glass* defined taxable income as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[18] It is the last part of this definition—complete dominion—that raises an issue as to the timing of realization with regard to Hard Forks.

One possible argument is that realization happens at the time of the Hard Fork. At that point, an owner of the original coin becomes (at least in theory) unconditionally eligible to claim the forked coin, and he or she therefore must include the value of the forked coin at that time. However, when an owner holds an original coin in an account maintained by an intermediary such as Coinbase, the timing of realization becomes murky. In that case, a financial intermediary—whether the owner's agent or not—is preventing the owner from controlling the forked coin, which arguably may prevent the owner from experiencing a realization event.[19] On the other hand, cryptocurrencies are virtual currency and can be transferred to other intermediaries or the owner relatively easily and quickly. Consequently, it can be argued that the owner has voluntarily failed

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[17] Other possible analogies to taxable transactions include dividends of property (§§ 301, 316), found property or treasure trove (Reg. § 1.61-14(a); *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969)), awards (*Hornung v. Commissioner*, 47 T.C. 428 (1967)), or free samples (*Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975)).

[18] 348 U.S. at 431.

[19] *See, e.g., Maryland Casualty v. U.S.*, 251 U.S. 342 (1920). Even if the owner does not hold an original coin through a third-party wallet, he or she may still take no action to claim the forked currency until the security risks have been sufficiently evaluated and mitigated.

to meet the conditions under which the forked coin can be claimed and is in constructive receipt of it.[20]

Amount Realized

Assuming realization, one must determine the amount realized, meaning, the value of the forked coin when realization occurs. Given the complexities in the cryptocurrency market, valuation is as much a problem of administrability and predictability as it is of consistency with existing U.S. federal income tax law.

After a Hard Fork occurs, there is a process of market price discovery. However, this process often takes place on multiple exchanges that do not "talk" to each other. As a consequence, the same type of cryptocurrency—even established cryptocurrencies such as BTC—may have different values on different exchanges at the same time. Thus, even though market values for a forked coin may emerge quickly (though, in some cases, a market may fail to materialize), the same coin may have different market values on different exchanges even within the same country at any point in time. Nonetheless, at the moment that a Hard Fork occurs—the first moment at which an owner of the original coin may obtain an interest in the forked coin—the forked coin arguably has no market value because it has not been previously traded and it is not clear whether a market will emerge for the coin.

We note that in some instances (such as in the case of BCH), an exchange may permit futures contracts in a forked coin to be traded before a Hard Fork occurs. However, to the best of our knowledge, no such websites constitute an "established market"—a concept to which many provisions in the Code refer as a method for determining market price—and therefore should not be used as a definitive source for determining the value of the underlying property (*i.e.*, the forked coin) for tax purposes.[21]

If one determines that realization occurs when an owner first has clear control over the forked coin resulting from a Hard Fork, then it is reasonable to argue that the fair market value of the forked coin must be determined at that time. It is reasonable to argue that in the case of third-party exchanges that also function as a wallet provider (*e.g.*, Coinbase), the amount realized would be the U.S. dollar value of the forked coin on that exchange at the time it is credited to an owner's account (*i.e.*, the first moment that the

[20] Reg. § 1.451-2. If the value of the forked currency is included in income immediately upon the fork, but the modifications to the blockchain are ultimately not adopted by participants on the network so that the fork is not permanent and the blockchain re-merges, the owner should arguably be able to take a loss equal to its adjusted basis in the forked currency. I.R.C. § 165(e)(2).

[21] *See, e.g.*, Reg. § 1.1273-2(f) (determining issue price for purposes of determining original issue discount).

intermediary elects to recognize the forked coin on behalf of the owner). As a result, the owner would report the fair market value of the coin at the time of crediting as ordinary income, since the forked coin was not received in a sale or exchange, and would take a basis in the forked coin equal to its fair market value at that time.

However, an owner who holds the forked coin through another wallet provider or technological method that recognizes the forked coin and credits it to an owner's account at the moment of the Hard Fork may include a very different amount in ordinary income due to the different timing of the realization event (*i.e.*, when the user obtained clear control over the forked coin). The owner may also be able to select the most favorable exchange rate by shopping the various exchanges. This is not necessarily a problem of fairness given that the owner has a choice regarding how he or she holds the original coin involved in the Hard Fork, but it is a problem of predictability and administrability (and an opportunity for taxpayers to attempt to game the U.S. federal income tax system).

B. Hard Fork as a Non-Realization Event

Given that a forked coin resulting from a Hard Fork shares transactional and ownership history with the original coin, one could also argue that the original coin has always included the future potential to create a forked coin. For example, one could argue that part of the potential of BTC has always been the creation of additional coins (such as BCH), and that such a possibility is capitalized into the market value of BTC. In other words, the forked coin is like the stock dividend in *Macomber* in that it simply represents part of the value of the original coin and therefor is more in the nature of a change in the form of ownership than a realization event. In this way, a Hard Fork is arguably similar to the birth of young from pregnant livestock, which generally has not been treated as a realization event.[22] Notably, the fact that BCH has modestly different properties from BTC should not be seen as conclusively establishing that a realization event has occurred; a calf has different properties from the cow that gives birth to the calf, and stock received in a nontaxable stock dividend need not be identical to the stock on which the dividend is paid.

If this position is accepted, the creation of BCH should not be treated as a realization event until the disposition of BCH by the owner (and taxed as a capital gain if the cryptocurrency is held as a capital asset). This position is supported by a reduction in

[22] *See, e.g.*, *Metz v. United States*, 10 AFTR 2d 5443 (E.D. Ky. 1962); *Gamble v. Commissioner*, 68 T.C. 800 (1977); Rev. Rul. 86-24, 1986-1 C.B. 80. Other possible analogies to nontaxable transactions include the sale of minerals extracted (Reg. § 1.61-3(a)) or timber cut from land (*cf* I.R.C. § 631(a)), the partition of property (Reg. § 1.61-6(a)), or the severance of a joint tenancy (Rev. Rul. 56-437, 1956-2 C.B. 507).

price of BTC that happened at the time of the Hard Fork with BCH.[23] One could argue that the reduction of BTC value was attributable to the split with BCH, the value of which was no longer integrated with the value of BTC. It is difficult, however, to empirically prove that the prices of BTC and BCH are so associated due to the volatility of both currencies.

Alternatively, one may view the forked currency as not materially different than the original currency under the standard of *Cottage Savings*. The owner continues to use the same private key that permitted the owner to spend BTC prior to the Hard Fork to access BCH after the Hard Fork, and each are verified by a subset of the same network of computers. In addition, the ownership history of both BTC and BCH trace back to the same block on the blockchain; any changes emerge only going forward.

Even if one accepts the position that a Hard Fork is not a realization event, an important question remains. Specifically, one has to decide how to divide the basis between the original coin and the forked coin. One possible approach would be to adopt rules similar to those used in stock distributions, in which the basis is split based on the fair market value of the original and distributed stock.[24] However, in such a case, it will be necessary to determine the value of the forked coin at the time of the Hard Fork. As discussed above, there are real practical difficulties with determining the value of a forked coin.

III. PROPOSAL FOR 2017

The original intent of the Section was to fully develop the issues discussed herein. However, given that multiple Hard Forks took place in 2017, it is apparent that these issues are pressing and must be addressed in time to be of assistance for taxpayers during the current filing season. Therefore, the Section decided to leave the full development of these issues for later and instead proposes a temporary solution to apply only for the 2017 tax year.

Under the proposed temporary solution, we recommend that the Service issue guidance that offers a safe harbor to taxpayers who were able to transact in a forked coin as a result of a Hard Fork occurring during the 2017 tax year. Such safe harbor would prescribe the following:

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[23] Laura Shin, *Bitcoin Cash Skyrockets, Bitcoin Price Drops As Civil War Continues*, FORBES (Nov. 12, 2017), https://www.forbes.com/sites/laurashin/2017/11/12/bitcoin-cash-skyrockets-bitcoin-price-drops-as-civil-war-continues/#3968e99135b5.

[24] Reg. § 1.307-1.

1. Taxpayers who owned a coin that was subject to a Hard Fork in 2017 would be treated as having realized the forked coin resulting from the Hard Fork in a taxable event.

2. The deemed value of the forked coin at the time of the realization event would be zero, which would also be the taxpayer's basis in the forked coin.

3. The holding period in the forked coin would start on the day of the Hard Fork.

4. Taxpayers choosing the safe harbor treatment as set forth in the guidance would be required to disclose this on their tax returns.

5. The Service would not assert that any taxpayer who availed themselves of the safe harbor treatment as set forth in the guidance has understated federal tax liability because of the receipt of a forked coin in a 2017 Hard Fork.

6. The Service, with input from the Section and other stakeholders, will continue to develop its position regarding the tax treatment for future Hard Forks, and such position may be different from the one noted above and will apply prospectively.

While the Section has not concluded that this is the proper U.S. federal income tax treatment of Hard Forks, we believe that such temporary solution represents a reasonable interpretation of current law. In addition, we believe that the temporary solution imposes a reasonable administrative burden on the Service and compliance burden on taxpayers in this filing season, as it avoids difficult timing and valuation issues.[25] It also minimizes the ability of taxpayers to benefit from hindsight depending on how the values fluctuated during 2017. Finally, by requiring disclosure, the Service will obtain valuable information about cryptocurrency transactions and taxpayers participating in them.

We acknowledge that the temporary treatment may result in capital gain as opposed to ordinary income treatment (assuming the cryptocurrency is held as a capital asset), but by assigning a zero value, it preserves tax on the full value of the forked currency for taxation when the taxpayer sells it. In addition, this approach restarts the holding period, thus resulting in sales occurring within a year being taxed as short-term capital gains.

The Section will continue to refine its position and is happy to assist the Service in developing a permanent position regarding the tax treatment of Hard Forks. The

[25] We note that the Service has previously adopted safe harbors to avoid difficult valuation issues. *See, e.g.*, Rev. Proc. 93-27, 1993-2 C.B. 343, *clarified by* Rev. Proc. 2001-43, 2001-2 C.B. 191.

Section also plans to comment on other issues in the cryptocurrency area and looks forward to prioritizing and working with the Service on those issues.

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Taxation of Cryptocurrency Hard Forks

Rachana Khandelwal
San Jose State University

Tax Enlightenment: Taxation of Cryptocurrency Hard Forks
- Rachana Khandelwal, MST Student

Background on Cryptocurrency

Cryptocurrency(CC) is a digital, decentralized, open source asset with its value entirely driven by market forces. CC holds no intrinsic value due to an absence of any asset backing. CCs such as bitcoin and altcoins (Ethereum, Dash, Monero, Zcash, etc.) are significantly different from traditional currencies such as the Euro and U.S. dollar. Traditional currency is a legal tender with a central bank backing and is generally globally accepted as a medium of exchange.

Transactions in cryptocurrency are recorded in a distributed ledger through a series of cryptographical blocks called Blockchain, a robust technology which makes it impossible to alter any recorded transaction.

CCs are stored in digital wallets and can be used to buy/sell via transactions over a peer to peer network. When an exchange takes place over a peer to peer network, the record of transactions is maintained between user addresses and not the actual users. A bitcoin address is an alpha-numeric code called a 'public key'. Each public key has a corresponding private key, which needs to be protected and stored safely by the user. The public key is used to receive bitcoin while the private key is to send bitcoin. When a user's wallet is hosted on a third-party platform such as an exchange, the user doesn't have any control over the wallet since the private key of the wallet is held by the exchange. However, this does not imply that the exchange is manipulating the user's fund. The exchange manages the user's wallet and executes the transactions only when it receives the authorization from the user.

CCs such as bitcoin and Ethereum are primarily obtained through 'mining', which involves solving complex mathematical algorithms on powerful computers. Once in circulation, it can be purchased from dedicated exchanges such as Coinbase and GDAX, or can be received as a payment for goods or services.

Cryptocurrency also comes into existence through an Initial Coin Offering (ICO)[1] or through *a hard fork.*

What is a Hard Fork?

As per the Safe Harbor for Taxpayers with Forked Assets Act of 2018 [2] "hard fork means, with respect to any convertible virtual currency, any material change in the shared digital ledger which is used to verify by consensus transactions in such currency if such change results in the maintenance of independent shared digital ledgers with respect to such currency."

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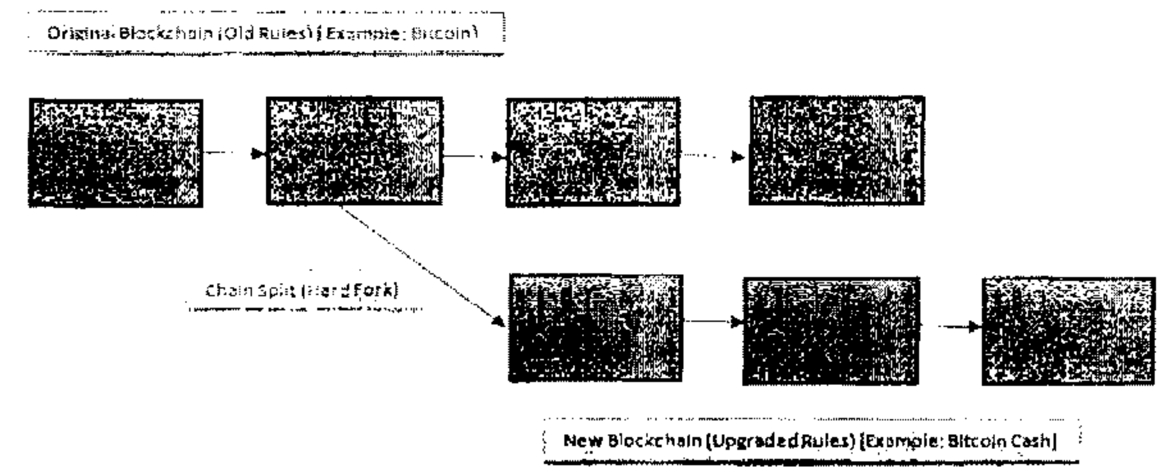
[1] ICO is funded by investors to develop a blockchain, digital tokens or a currency. According to the *Bitcoin Market Journal*, August 6, 2018, ICOs' raised $13 billion; https://www.bitcoinmarketjournal.com/biggest-icos-roi/.

[2] Rep. Emmer, Safe Harbor for Taxpayers with Forked Assets Act of 2018, H.R.6973, available at https://www.congress.gov/bill/115th-congress/house-bill/6973/text?format=txt&r=91.

In general, a hard fork (also known as a chain split) occurs when a blockchain network protocol is permanently upgraded by implementing major changes to the existing protocol, thereby creating a separate blockchain with a new cryptocurrency. Such a change in the protocol is not backward compatible and hence all the future transactions are operated with a different set of rules under the new protocol.



Source: Rachana Khandelwal

Usually, a hard fork takes place when the blockchain network participants (miners) arrive at a consensus that the software needs to be upgraded for reasons such as to increase the scalability of a block size, make the blockchain more efficient, lower the transaction costs or make the blockchain robust and immune from potential security breaches.

The new blockchain retains the pre-forked transaction history of the owners of the coins. However, due to incompatibility in the software, a transaction that is accepted by the new protocol is rendered invalid on the old one and is not accepted by the non-upgraded nodes in the network.

In 2016, Ethereum went into a hard fork in Ethereum Classic (old) and Ethereum (new) to improve their broken blockchain network. The old blockchain was subject to hacking and resulted in the financial loss of $64 million.[3] This led to a launch of new improved software which tightened the security to prevent such losses in the future.

Bitcoin has undergone several hard forks such as Bitcoin XT (December 2014), Bitcoin Classic (February 2016), and Bitcoin Cash (August 2017).[4] So far, the most successful bitcoin blockchain

[3] Jonathan Ore, How a $64M hack changed the fate of Ethereum, Bitcoin's closest competitor, CBC News, August 28, 2016, available at https://www.cbc.ca/news/technology/ethereum-hack-blockchain-fork-bitcoin-1.3719009

[4] Nathan Reiff, A history of Bitcoin hard forks, April 25, 2018, available at https://www.investopedia.com/tech/history-bitcoin-hard-forks/

split is the Bitcoin Cash owing to its wide acceptance by the cryptocurrency users and ranked fourth largest by market capitalization of approximately $9 billion.[5]

Tax Treatment

In March 2014, the IRS provided general guidance through Notice 2014-21[6] to treat cryptocurrency as 'property' for federal tax purposes. Thus, the tax rules applicable to a property transaction are also applicable to the transactions undertaken using CC. However, since 2014 there has been a significant transformation in the use and operation of cryptocurrency, which was originally viewed as an asset obtained by mining or purchased from a dedicated exchange.

In 2017, the hard fork of bitcoin into Bitcoin Cash presented an altogether a new challenge in the tax treatment of a newly obtained currency via chain split. The IRS has been silent on the tax treatment of a hard fork, perhaps because of the subtleties involved in determining the point of taxation for such events. As mentioned above the valuation of the forked coin may be a challenging aspect given the unpredictable frequency of a hard fork. In addition, the nature and newness of a hard fork has no existing counterpart in existing transactions to aid in identifying any obvious tax treatment.

Character of Income

A. Hard Fork as Ordinary Income

Per IRC section 61(a), under general tax principles, gross income includes "all income from whatever source derived," except as otherwise provided.[7] Treasury Regulations §1.61-1(a) further explains it to include income realized in any form such as money, property or services.

In *Commissioner v. Glenshaw Glass*, the U.S. Supreme Court further broadened the interpretation of IRC 61(a) and explained, income as a "taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it.[8] The Court emphasized that the determinative factors of gross income include- a) undeniable accession to the wealth, b) clearly realized, and c) complete dominion over such income.

Application of these three factors to a hard fork, produces the following analysis.

a) Undeniable accession to the wealth
   In *Haverly v. U.S.* [9], the court determined that the taxpayer's receipt of unsolicited textbooks, and subsequent claiming of a charitable tax deduction upon donation of such textbooks constituted an accession to wealth. In the case of a hard fork, the forked coin is an economic gain to the taxpayer because of the taxpayer's holding of the original coin. The taxpayer generally receives an equal number of forked coins as the original coins held in their wallet at no cost. In substance, the taxpayer is in receipt of free property representing an increase

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[5] Top 100 cryptocurrencies by market capitalization available at https://coinmarketcap.com/coins/ (as of August 22, 2018).

[6] Notice 2014-21, CB 938 available at https://www.irs.gov/irb/2014-16_IRB#NOT-2014-21.

[7] Code Section 61(a).

[8] Com. v. Glenshaw Glass Co, 348 US 426 (1955).

[9] 513 F. 2d 224 (7th Cir., 1975).

in the wealth of the taxpayer. However, the value of such property at the time of hard fork may not be determined and might be viewed as no value at the time of creation. In addition, the new coin can also be viewed similarly to a stock split (although the new coin is different), in that the coin emerges from the existing coin.

The hard fork of bitcoin resulting in the split of bitcoin and creation of a new forked coin called Bitcoin Cash. This represented unsolicited property bestowed upon the holder of a bitcoin. Arguably, the fact that the Bitcoin Cash is freely available for use by the taxpayer satisfies the factor of 'undeniable accession to the wealth'. While a market might emerge for the coin, arguably, at the moment of its creation, it had no value separate from the original coin.

b) Clearly realized

Taxpayers' entitlement to the forked coin reflects their ability to enter into a transaction using the forked coin. The income is said to be clearly realized when it is actually or constructively received. The doctrine of constructive receipt is explained under Treasury Reg. §1.451-2(a). The regulation stipulates that income is realized when the taxpayer has a control over that income whether or not it is actually received by the taxpayer. However, in the case of a hard fork, this may or may not be satisfied due to two categories of wallet—custodial and non-custodial.

i) Custodial Wallet

A user owning cryptocurrency in a custodial wallet, such as an exchange, may not be able to claim the forked coin unless the exchange recognizes and supports it. In August 2017, prior to the bitcoin hard fork, Coinbase, a cryptocurrency exchange notified its bitcoin customers that it would not support Bitcoin Cash and the users would not be able to access Bitcoin Cash from their wallet.[10] In such a case, the income received was substantially restricted and legally controlled by the custodian of the wallet and it might not be construed as a constructively received unless the exchange allows the user to access it.

ii) Non-custodial wallet

A non-custodial wallet does not involve any third party, and the user exercises complete control over the wallet. Thus, the user is said to constructively receive income as soon as the forked coin appears in his wallet.

Hence, the unconditional and unrestrictive access to forked coins such as Bitcoin Cash or Ethereum received by the taxpayer as a virtue of being an owner of bitcoin or Ethereum Classic, might be viewed as a realization of income at the time of the hard fork. However, as noted earlier, the coin might have a value of zero at that time.

[10] "When will Coinbase exchange Accept Bitcoin Cash," BitcoinExchangeGuide available at https://bitcoinexchangeguide.com/coinbase-exchange-accepts-bitcoin-cash-bch/.

c) Complete dominion
A taxpayer is said to have complete dominion over income when the taxpayer is able to exercise legal control over it. A cryptocurrency user holding a custodial wallet hosted on a third-party platform such as Coinbase establishes legal control over the forked coin only when unconditional and unrestricted access is allowed. On the other hand, a user holding cryptocurrencies in a non-custodial wallet might be considered as having complete dominion as soon as the forked coins appear in the wallet. Again though, there remains the issue as to the value of the forked coin and whether the wallet holder has done anything to exercise control over the new coin.

The above three-factor analysis is crucial in determining whether the forked coin obtained is income. However, there are significant practical challenges when a user's wallet is hosted by a third-party platform such as Coinbase. In August 2017, Coinbase was apprehensive of treating Bitcoin Cash as a legitimate currency due to the security risks to digital assets.[11] In this case, the private key of a user's wallet was held with Coinbase and therefore the user could not access Bitcoin Cash unless Coinbase allowed them to do so. This brings a severe restriction on the user along with the uncertainty based on the third party's decision. In such situation, a realization event is delayed, and the price may not be accurately assessed due to a highly volatile cryptocurrency market.

B. Hard fork treated as a growth in an investment

Can the forked coin be viewed as a dividend paid on the original coin, which is treated as property per Notice 2014-21? In *Eisner v Macomber*[12], the Supreme Court held that a stock distributed as a dividend is not income. The Court observed that a "stock dividend is nothing, but a piece of paper received by the stockholder of the company and the stockholder has received nothing out of company's assets for its separate use and profit." Further, the Court emphasized that "the stockholder is subject to the business risks of the company which may result in wiping out the entire investment of the stockholder."

Applying this analogy to a hard fork, the forked coin can be construed as a stock dividend received by the user resulting in an increase in the number of coins, but not an increase in value. In addition, the original coin is subject to operational and security risks[13] like the business risks of a company distributing stock as a dividend.

[11] "When will Coinbase exchange Accept Bitcoin Cash," BitcoinExchangeGuide available at https://bitcoinexchangeguide.com/coinbase-exchange-accepts-bitcoin-cash-bch/.

[12] Eisner v. Macomber, 252 U.S. 189 (1920).

[13] Samson Mow, "The Bitcoin Cash Fork Was a Dangerous Trick," fortune.com available at http://fortune.com/2017/08/07/bitcoin-cash-bch-hard-fork-blockchain-usd-coinbase/.

C. Valuation of the forked coin

Assigning a value to the new currency is crucial and the most challenging aspect in the taxation of a hard fork. If the IRS decides to treat the forked coin as ordinary income, then the basis possibly could be the price at the time of launch, i.e. the opening price.

In its comment letter (May 2018) to the IRS, the AICPA suggested that the price discovery at the time of a fork can be considered as near zero and therefore for tax purposes, it should have a zero basis and result in no income at that time.[14] A similar position was offered by the American Bar Association's (ABA) Section of Taxation in its comment letter (March 2018) to the IRS suggesting the valuation and the tax treatment of forked coin.[15]

The rationale behind assigning a zero value is the uncertainty in the survival of the new coin and the high volatility of the cryptocurrency market. Also, as discussed in the previous section, factors such as third-party support for custodial wallets delays the (constructive) receipt of the new coin.

Other countries on the hard fork

Australia

The Australian Tax Office (ATO) issued a guideline that taxpayers do not derive any ordinary income or capital gain when they obtain a new cryptocurrency as a result of the hard fork in the existing blockchain. Further, if the taxpayer held the cryptocurrency as an investment, the basis for the new cryptocurrency would be zero for the purpose of computing capital gain. If a cryptocurrency is held for a sale or exchange in a business, the new cryptocurrency obtained during a hard fork would be treated as a trading stock, and it must be accounted as income at the end of the financial year.[16]

United Kingdom

Her Majesty's Revenue and Customs (HMRC) treats cryptocurrency as an asset and therefore a gain on the sale or use of cryptocurrency is a capital gain. HMRC has specified in its internal manual on Capital Gains that the basis of the new cryptocurrency arising as a result of a chain split should be traced to the cost of the original asset. Thus, the acquisition cost of the old

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[14] AICPA's comment letter to the IRS, May 30, 2018, available at https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180530-aicpa-comment-letter-on-notice-2014-21-virtual-currency.pdf

[15] Chair, Karen L. Hawkins, American Bar Association Section of Taxation, Tax Treatment of Hard Forks for the Taxable Year 2017, March 19, 2018, available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/031918comments2.authcheckdam.pdf

[16] Australian Tax Office, Tax Treatment of cryptocurrencies in Australia specifically Bitcoin, Chain Splits, available at https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin/?anchor=Transactingwithcryptocurrency#Transactingwithcryptocurrency.

cryptocurrency would be apportioned between the old and the new cryptocurrency obtained in the course of a hard fork.[17]

Germany

In a Cryptotax seminar hosted by the Frankfurt School of Finance & Management in March 2018, the school suggested treating a hard fork similar to stock splits and consider the market value at the time of the split as a cost of acquisition of the new cryptocurrency.[18]

Conclusion

The evolution of blockchain technology and the cryptocurrency market has given rise to an increase in tax complexities. There are diverse interpretations of a chain split around the world and as a consequence, the tax treatment of hard fork varies between countries. Not many countries have issued guidelines on chain splits and such an event needs to be interpreted based on the particular facts and circumstances and that country's tax law.

As more and more currencies come into existence through hard forks, it is going to be challenging for the tax authorities in understanding, designing and regulating the tax treatment.

The character, timing and the amount of income are difficult to identify and define within the tax framework. Therefore, these aspects need to be carefully evaluated to make a tax law for a complex subject like a hard fork. Specific guidance is also needed to better ensure consistency of how owners experience a hard fork of CC treat it for tax purposes.

Acknowledgement

I would like to express my deep gratitude to **Professor Annette Nellen** for her expert guidance and helpful critique.

[17] HMRC Internal Manuals, Capital Gain Manual, Introduction, and Computation: chargeable assets: intangible assets: cryptocurrencies, last updated May 9, 2018. available at https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg12100.

[18] Norbert Gehrke, German Income Tax on Virtual Currencies, Medium.com, March 11, 2018 available at https://medium.com/@norbert.gehrke/german-income-tax-on-virtual-currencies-18bc35990457.

AMERICAN INSTITUTE OF CPAs

Request for Guidance Regarding Virtual Currency
(Notice 2014-21)

1. Expenses of Obtaining Virtual Currency

Overview

Virtual currency is property that exists in electronic form and used as a store of value, as well as to acquire goods and services, as well as other virtual currencies. Users of virtual currency may exchange it for physical money, such as the United States Dollar (USD), or other foreign currencies. Users can also obtain new virtual currency through "mining," which is the process of having computers compete to solve complex mathematical problems. The individuals with the computers that solve the problems are the "winners" that receive newly mined blocks of virtual currency.

Section 4, Q&A-8 of Notice 2014-21 states that "when a taxpayer successfully 'mines' virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income."[3] This language implies that mining is akin to a service activity, rather than a production activity where income is not realized until disposition of the property.[4] Therefore, it is appropriate to treat the costs of mining virtual currency similar to expenses incurred in providing other services (*i.e.*, expensed as "paid or incurred").[5]

Suggested FAQ

Q-1: Are the costs of acquiring virtual currency through mining or similar activities expensed as incurred, similar to costs incurred for providing other service activities?

A-1: Yes. Virtual currency mining or similar activities produce virtual currency treated as ordinary income in the year it is mined and the expenses of mining are deducted as incurred. The matching of income and expenses are consistent with other service activities. Virtual currency mining equipment is capitalized and depreciated like any other property whose useful life extends beyond one year.

2. Acceptable Valuation and Documentation

Overview

Section 4, Q&A-5 of Notice 2014-21 refers to exchange rates established by market supply and

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[3] See IRS Notice 2014-21, Section 4, Q&A-8.
[4] IRC section 1001.
[5] IRC section 162.

demand used to determine the fair market value of virtual currency in USD as of the date of payment or receipt. It also recommends that taxpayers use a "reasonable manner that is consistently applied" to calculate the fair market value of virtual currency. Further guidance and examples are necessary to define "reasonable manner."

With respect to Bitcoin, there are a few published exchanges and price indexes and the values reported on each exchange and price index at any time of the day are unlikely the same. The following examples demonstrate the variations in value across different exchanges and price indexes at a given date and time.

Bitcoin Values on January 31, 2017

The Bitcoin values as reported on the following virtual currency price indexes: on January 31, 2017 at 4:00 pm (Eastern Time):

• Bitcoin Average	$ 976.67
• Coindesk	$ 967.67
• Google	$ 972.22
• Winkdex	$ 950.75

The Bitcoin values as reported on the following virtual currency exchanges on January 31, 2017 at 4:00 pm (Eastern Time):

• Bitstamp	$ 963.99
• Coinbase	$ 960.05
• Kraken	$ 975.00

Bitcoin Values on June 30, 2017

The Bitcoin values as reported on the following virtual currency price indexes on June 30, 2017 at 4:00 pm (Eastern Time):

• Bitcoin Average	$ 2,458.14
• Coindesk	$ 2,499.98
• Google	$ 2,457.82
• Winkdex	$ 2,502.24

The Bitcoin values as reported on the following virtual currency exchanges on June 30, 2017 at 4:00 pm (Eastern Time):

• Bitstamp	$ 2,465.49
• Coinbase	$ 2,486.09
• Kraken	$ 2,548.00

Suggested FAQs

Q-2: Are taxpayers allowed to use an average of different exchanges?
A-2: Yes. Taxpayers are allowed to use an average of different exchanges as long as they are consistent in how they calculate the valuation.

Q-3: May taxpayers use the average rate for the day to calculate the exchange rate?
A-3: Yes. Taxpayers may use the average rate for the day to calculate the exchange rate, provided they are consistent in how they make this determination for every virtual currency transaction.

Q-4: May taxpayers rely on virtual currency tax software as a reasonable and consistent method for determining fair value?
A-4: Yes. Taxpayers may rely on virtual currency tax software as a reasonable and consistent method for determining fair value if the software is consistently using aggregated price data.

Q-5: Are taxpayers allowed to have a combination of transactions using time stamps or dates (without a time stamp) for one virtual currency, or among a group of virtual currencies, and still have this method considered as consistently applied?
A-5: Yes. Taxpayers should use time stamps whenever possible and transactions with dates should only have a reasonable and consistent method applied, as outlined in this section. A virtual currency, such as Bitcoin, meets this test in both methods because a combination of time stamps and dates are used.

Q-6: May taxpayers use a different method for determining fair value for transactions in each of their virtual currency wallets and exchanges?
A-6: Taxpayers should apply the same reasonable and consistent method to all the transactions on a per virtual currency wallet or exchange basis. Taxpayers should use time stamps whenever they are available. Otherwise, the use of a reasonable and consistent method should apply to the transactions. Taxpayers may have one method applied to one wallet and another method applied to another exchange when determining the fair value of all the Bitcoin transactions. Taxpayers using this combination of methods can meet the overall test for reasonable and consistent determination of fair value.

Q-7: May taxpayers use a virtual currency price index that aggregates the prices from major exchanges, such as the Coindesk Bitcoin Index (XBP)?
A-7: Taxpayers may use a price index provided they are consistent in applying prices for every virtual currency transaction.

3. Computation of Gains and Losses

Overview

A "convertible" virtual currency is a virtual currency that has an equivalent value in real currency, or acts as a substitute for real currency. It usually has a measurable value in real money and what makes it convertible lies in its ability to exchange for real currency based on its determinable value in the market. The most popular form of convertible virtual currency is Bitcoin.

The treatment of convertible virtual currency as non-cash property signifies that any time virtual currency is used to acquire goods or services, a barter transaction takes place and parties need to know the fair market value (FMV) of the currency on that day. The party exchanging the virtual currency for goods or services will need to track the basis of his or her currency to determine whether a gain or loss has occurred and whether it is a short-term or long-term transaction. This determination involves a significant amount of recordkeeping even if the transaction is valued at under $10.

Currently, there are no alternative tracking methods provided for such transactions other than for securities under Treas. Reg. § 1.1012-1(c) (*e.g.*, first in first out (FIFO)). Therefore, taxpayers are required to specifically identify which virtual currency lot was used for each transaction in order to properly determine the gain or loss for that particular transaction. In many cases, it is impossible for a taxpayer to track which specific virtual currency was used for a particular transaction.

The IRS should allow FIFO treatment under section 1012 as an election and/or option. It is not always practical to perform the tracking process for specific identification. However, although specific identification can present a tracking challenge for taxpayers, it is imperative that the IRS allow this method. Specific identification is needed in order to provide a mechanism to address a double capital gain paradox that can arise due to the fact that some virtual currencies can only exchange for other virtual currencies (and not for USDs). It is unfair for taxpayers to incur gain from a series of related sales that exceed the ultimate transaction proceeds (as explained in the Bitcoin conduit problem in Appendix A).

Suggested FAQ

Q-8: May a taxpayer choose either the specific identification method or the FIFO method as the accounting method for computing capital gains and losses?

A-8: Yes. The taxpayer may choose either specific identification or FIFO as long as the method is consistently applied from year to year.

4. Need for a *De Minimis* Election

Overview

Some taxpayers may only have a minimal amount of virtual currency that is designated for making small purchases (such as buying coffee). Tracking the basis and FMV of the virtual currency for each of these small purchases is time consuming, burdensome, and will yield a *de minimis* amount of gain or loss.[6] A binding election applicable for a specified amount of virtual currency is beneficial to taxpayers.

Currently, section 988(e)(2) allows for an exclusion of up to $200 per transaction for foreign currency exchange rate gain, if derived from a personal transaction. The same exclusion should apply to virtual currencies even though they are considered property rather than foreign currency.

Suggested FAQ

Q-9: May individuals use a *de minimis* rule for virtual currency similar to the section 988(e)(2) exclusion of up to $200 per transaction for foreign currency exchange rate gain?

A-9: Yes. Individuals may use a *de minimis* rule, similar to section the 988(e)(2) exclusion, for virtual currency transactions to alleviate the burden or recordkeeping for individuals who use virtual currency as a medium of exchange. This *de minimis* rule allows taxpayers to exclude transactions resulting in $200 or less of gain.

5. Valuation for Charitable Contribution Purposes

Overview

A charitable contribution of property with a value in excess of $5,000 requires a qualified appraisal from a qualified appraiser. Exceptions exist for "readily valued property" such as publicly traded securities. The rationale is that the prices for these publicly traded stocks are available on established exchanges, thus not requiring a qualified appraisal. The same is true for most, if not all, types of virtual currencies. That is, various exchanges publish the value of the currency on any given day. Thus, a taxpayer donating virtual currency worth more than $5,000 should not have the requirement to obtain a qualified appraisal, provided the donor documents the transfer under the usual section 170(f) rules and maintains proof of the value of the virtual currency on at least two established exchanges on the date of the donation. This use of at least two exchanges recognizes that unlike publicly-traded stock, which has a single price, the value of virtual currency can vary slightly among different published exchanges. In addition, the use of at least two exchanges provides support that the donated currency is widely recognized.

[6] See Senate Committee on Finance and House Ways and Means letter from Senator Hatch and Congressmen Brady and Buchanan, to the IRS Commissioner, suggesting that the IRS provide a *de minimis* rule to remove practical barriers to transactional use of virtual currencies, dated May 17, 2017.

Suggested FAQ

Q-10: Is a charitable contribution of virtual currency valued in excess of $5,000 treated the same as contributions of publicly traded stock which do not require a qualified appraisal?

A-10: Yes. Virtual currencies that have a readily determinable market value on at least two commonly used exchanges are treated similar to contributions of publicly traded stock under section 170(f) and do not require a qualified appraisal. The taxpayer must document, and calculate the average of, the fair market value on at least two exchanges (at the date and time of the contribution) and the basis of the virtual currency contributed.

6. Virtual Currency Events

Overview

Price discovery is an important concept affecting how taxation is applied to virtual currencies (see Appendix B). Price discovery refers to the act of determining the proper price of a security, commodity, or good or service by studying market supply and demand and other factors associated with transactions. Virtual currency events including chain splits, airdrops and giveaways are subject to price discovery and therefore, create a unique challenge in determining a USD translation for virtual currencies that newly come into existence.

A chain split occurs when one blockchain splits into two separate virtual currencies. An airdrop is a distribution of new virtual currency tokens, on a pro-rata basis, to existing holders of a particular virtual currency based on a snapshot of the owners' balances at a specific point in time. Unlike an airdrop event where tokens are distributed pro-rata, a giveaway event occurs when a fixed amount of virtual currency is given to a taxpayer for creating an account on a related wallet.

Existing virtual currencies with a long track record are traded on multiple exchanges and likely have significant trading volume, thus yielding sufficient data for USD translations and the determination of fair value. This same data is not available when virtual currencies come into existence at time zero, which is the moment in time that the price discovery process begins. By definition, the USD translation for virtual currencies happens at the exact second a transaction takes place (as if there was a transaction time stamp post price discovery). When this method is applied to chain splits, airdrops, and giveaways, the price discovery at time zero - the exact second of the transaction—is $0, in theory. The price discovery process begins when the virtual currency is listed on an exchange and the trading process begins to produce price history. Price discovery may start on the same day as the virtual currency event. However, in many cases, price discovery and exchange listings do not take place for several days because virtual wallet software and exchanges must upgrade their technology and system rules to make it compatible with the new virtual currency, particularly in the event of a chain split. (See Appendix C for a detailed explanation.)

Regardless of whether a virtual currency transaction is considered ordinary income or whether any basis requires allocation, price discovery results in a zero value. If the transaction in question would have otherwise been considered ordinary income,[7] the amount received as zero value also becomes the basis in that virtual currency and the beginning of the holding period becomes the date coinciding with that value.

Virtual currency resulting from chain splits are property that are unsolicited by the taxpayer. Nothing compels individuals to claim these coins and normally, most individuals take no action at all until the risks associated with the chain split and its new coins are evaluated and mitigated. When a taxpayer makes the decision to take action by exercising authority, dominion, and control over a virtual currency, then the taxpayer acquires access to his/her chain split coins. In regards to Bitcoin, a taxpayer could exercise dominion by recognizing income upon performance of the coin splitting action.

> *Example:*
> A taxpayer may use a splitter tool to split the original Bitcoin into Bitcoin (BTC) and Bitcoin Cash (BCH), two separate virtual currencies. Taxpayer A may exercise dominion and control within days after the split when BCH is valued at $400 while Taxpayer B may exercise dominion of control months later when BCH is valued at $2,000. This scenario demonstrates the wide variation in potentially recognizable income.

Attempting to create a mechanism or a set of rules for price discovery or price allocation, which can only take place at a moment in time after the transaction occurs, would create an undue burden for taxpayers and result in an unlimited number of approaches, inconsistently applied. Taxpayers could apply a range of reasonable approaches to determine a USD fair value for chain splits, airdrops, and giveaways. However, they should have consistent application from one virtual currency to the next as these practices can give rise to possible manipulation. An election similar to what is allowed under section 83(b) (see Appendix D for sample draft election) would offer taxpayers some flexibility while providing a method for consistent application with new virtual currency events.

The FAQs below address the following virtual currency events:

a. Chain Splits
b. Airdrops
c. Giveaways
d. Token Swaps
e. Staking

a. Chain Splits

Blockchains are subject to soft forks, hard forks, and chain splits. A soft fork is a change of the blockchain rules that creates blocks still recognized as valid by the old software, even though the rules are changed. A hard fork is a major change in the blockchain protocol rules

[7] IRC section 1222 requires sale or exchange of a capital asset in order to generate capital gain or capital loss.

where the software validating according to the old rules will see any blocks produced according to the new rules as invalid.[8] Every chain split results from a soft or hard fork. Both soft and hard forks create a split, but a hard fork is meant to create two separate blockchains while a soft fork results in only one. Also, with virtual currency forks, there is a "snapshot," which includes the date when the fork occurs and a specific block number where the virtual currency separated.

On August 1, 2017, a chain split occurred within the Bitcoin network system that resulted in two versions of the Bitcoin blockchain and two separate virtual currencies, both of which share the identical parts of the blockchain prior to the August 1, 2017 split. Taxpayers who held Bitcoin (BTC) before the split on August 1 automatically received one equivalent unit of Bitcoin Cash (BCH) for each unit of Bitcoin (BTC), resulting in a separate financial instrument that possesses a liquid market value.

BTC and BCH are initially a conjoined virtual currency until they are split via a splitting tool- where a wallet feature or an exchange splits them on behalf of the owner/customer. An action must take place to separate a conjoined virtual currency into two. If the taxpayer controls the private key, then BTC and BCH remain conjoined as BTC-BCH until the taxpayer takes action to separate them.

A private key is a long number that allows an owner to spend his/her virtual currency. Owners of virtual currencies can keep private keys on computer files. Generally, an owner could also print the key on paper and store it in a secure location (*e.g.*, a safe).

If the taxpayer does not control the private key, which is the case when virtual currency is held on a centralized exchange, then the BTC-BCH remain conjoined until, and/or if, the third party exchange separates them. Therefore, two blockchains are permanently conjoined until a taxpayer or an exchange takes action to split it into two separate virtual currencies.

The sequential stages of a full chain split are as follows:

1. BTC: One virtual currency.
2. A fork occurs, resulting in a chain split.
3. BTC-BCH: One conjoined virtual currency, where the original blockchain now has two branches.
4. Splitting action takes place.
5. BTC and BCH: Two separate virtual currencies.

The price discovery and fair value of BCH at the time of the chain split is zero. The taxpayer's basis in BTC is not allocated and the basis in BCH becomes zero.

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[8] See article: "The Differences Between A Hard Fork, A Soft Fork, And A Chain Split, And What They Mean For The Future Bitcoin," by John Light, dated September 25, 2017.

b. Airdrops

An airdrop is a pro-rata distribution of a new virtual currency based on a snapshot of the virtual currency address balances of an existing blockchain at a specific point in time. The snapshot and the distribution dates (two different points in time) are communicated in advance. Therefore, taxpayers may purchase one virtual currency that entitles them to another via airdrop.

Example:
In 2016, NXT holders were entitled to 0.5 Ardor (ARDR) for every NXT token. If the taxpayer had 24,000 NXT, they received 12,000 ARDR after an NXT blockchain snapshot was completed. However, the taxpayer must have held NXT in the NXT client (wallet) and not on an exchange. The NXT client is "transparent" with the NXT blockchain, which allows a snapshot of every NXT address containing that specific type of virtual currency. The airdrop is completely independent of the NXT blockchain. The ARDR token is compatible with the NXT client and the pro-rata amount of new ARDR automatically appeared in a user's wallet on the distribution date.

c. Giveaways

A giveaway occurs when a fixed amount of virtual currency is given to a taxpayer for creating an account (and related wallet) and verifying their identity via Facebook, for example. The identity verification prevents the creation of multiple accounts for the same person and thus, gaming of the system. The giveaway lasts for a period of time (*e.g.*, 30 days) or when a certain amount of tokens are claimed.

Example:
Stellar launched in 2014 and in May of 2017, Stellar gave away 500 Lumens, their native virtual currency, to anyone who created an online account (wallet). The giveaway is not based on owning any other virtual currencies and the act of "signing up" and creating an account entitles the taxpayer to the free tokens. This giveaway process is distinctly different from an airdrop, where a taxpayer must own another virtual currency at a specific point in time and the amount of tokens received by the taxpayer is pro-rata based on a blockchain snapshot.

Suggested FAQs

Q-11: Are virtual currency airdrops considered ordinary income?
A-11: Yes. Virtual currencies received from airdrops are akin to a bonus or a free prize. Taxpayers should include the amount as ordinary income based on the fair value of the token on the date of receipt. The income recognized becomes the basis in the virtual currency. The holding period begins on the date of distribution and is the first day of the holding period.

Q-12: How do taxpayers report virtual currency events, including chain splits, airdrops, giveaways, or other similar activities?

A-12: Within 30 days of the event, taxpayers may report the event by making an "Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer," similar (but not subject) to the process for making an election under section 83(b). If the virtual currency is a capital asset in the hands of the taxpayer, future disposition of the asset will generate a capital gain or loss and the income reported becomes the basis in the virtual currency. (See Appendix D.)

Q-13: How should taxpayers report the Bitcoin split that occurred in August of 2017?

A-13: Taxpayers have the option to report events as they deem appropriate. However, if they choose to make an "Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer," the IRS will not challenge that method of treatment for 2017. Specifically, a taxpayer makes the election that states they received Bitcoin Cash in the August 2017 split event and the currency has zero basis. A taxpayer should file this election with the 2017 tax return by the extended due date.

Q-14: How is a virtual currency event (*e.g.*, chain splits, air drops, giveaways, etc.) reported when a taxpayer does not make an "Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer?"

A-14: If a taxpayer does not make the election, then the virtual currency event is reported as ordinary income when a taxpayer later disposes of the virtual currency received in a prior event (where the election was not made).

Q-15: Prior to the effective date of IRS guidance on the taxation of virtual currency events, how should taxpayers report these events (*e.g.*, chain splits, air drops, giveaways, etc.)?

A-15: Taxpayers may make the "Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer," within 60 days of the release of IRS guidance on this issue.

Q-16: May a taxpayer make the "Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer" if a third party virtual currency exchange issues the chain split coins, BCH for example, on a date after the virtual currency event happened?

A-16: Yes. Within 30 days of the event, taxpayers may report the event by making an "Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer."

d. Token Swaps

A token swap occurs when the developers of a virtual currency decide to move to a new or existing cryptographic protocol, thus requiring virtual currency holders to move their tokens from an existing wallet to a new wallet supported by the new protocol. During this process, the old blockchain is abandoned in favor of a new and different blockchain. The developers provide a special token swap virtual currency address to facilitate the swap offered for a specified period of time. After this period of time, owners may no longer swap the tokens and they become worthless. The original virtual currency is "burned" or destroyed when it is sent to the swap address and a new version of the currency is sent to the new virtual currency address provided by the taxpayer.

For example, Storj, a file sharing project, originally issued its SCJX token on the Counterparty protocol and moved to the Ethereum protocol, renaming the token to STORJ. Taxpayers had to burn their SCJX for STORJ on a 1:1 ratio basis. The swap is a maintenance activity; therefore, the taxpayer would simply use the basis in the old tokens as the basis for the new tokens. In the case where a swap is other than a 1:1 ratio, the basis is allocated on a pro-rata basis with the same total USD amount. If taxpayers fail to make the swap within the specified expiration window and results in worthless virtual currency, they should account for this transaction by reporting it in the same way a worthless security or other investments are reported.

<u>Suggested FAQs</u>

Q-17: Are token swaps considered a taxable event?
A-17: No. When one virtual currency is burned in exchange for another virtual currency (as required when the developers of one cryptographic protocol and/or blockchain decide to adopt a new and different cryptographic protocol and/or blockchain), the basis and holding period of the original virtual currency is applied to the new virtual currency version. If the swap is other than a 1:1 basis, the total value of the original virtual currency is divided by the number of new tokens received.

Q-18: If a taxpayer fails to execute a token swap within the specified time frame and the tokens are no longer eligible to swap, is this occurrence considered the same as a worthless security under section 165(g)?
A-18: Yes. Taxpayers should report virtual currencies that become worthless on Form 8949, *Sales and Other Dispositions of Capital Assets*, thus applying the same methodology used for worthless securities.

*e. **Staking***

Staking is participating in the security of a "proof of stake" based cryptographic algorithm-blockchain. This participation occurs when an individual owns a virtual currency with the expectation of receiving a probabilistic reward of the same virtual currency. The taxpayer must complete an act of staking to receive the reward because it does not happen automatically. The more virtual currency a taxpayer stakes, the higher the reward.

Unlike "proof of work," where the algorithm rewards miners who solve mathematical problems to create new blocks, proof of stake occurs when the creator of a new block is chosen in a deterministic way, depending on their wealth or "stake."

Virtual currency received from staking is treated as ordinary income in the same manner Bitcoin mining rewards are treated as ordinary income for proof of work based mining rewards. Proof of stake and proof of work are the principal algorithms for securing virtual currency networks. However, there are many other versions available, including hybrid versions. Therefore, any act of participating in the securing of virtual currency, with the expectation of virtual currency as a reward, should receive ordinary income taxation treatment.

Suggested FAQ

Q-19: Is virtual currency staking considered ordinary income from services, the same treatment applied to virtual currency mining?

A-19: Yes. Staking is akin to virtual currency mining and treated as ordinary income. The income recognized becomes the basis in the virtual currency and the holding period begins on the date the staking rewards are received. Expenses, if any related to staking, are deducted as ordinary expenses and expensed as incurred.

7. Virtual Currency Held and Used by a Dealer

Overview

When a business buys and sells virtual currency to/from customers, its character becomes inventory similar to other goods held for sale.

Suggested FAQs

Q-20: If a dealer is in the business of buying and selling virtual currencies to customers, what is the character of the virtual currency in the hands of the taxpayer?

A-20: Virtual currency is property and its character is considered inventory when a dealer buys and sells virtual currencies to customers in the ordinary course of business. The sale of virtual currency is ordinary income and the inventory sold becomes the cost of goods sold. This type of business is a virtual currency exchange or a dealer. A virtual currency dealer can also have virtual currency held as property with related capital gain and loss calculations when it is used to pay for goods and services outside of the business context. (See additional details in section below on the treatment of "Dealers and Traders of Virtual Currency.")

Q-21: Do the uniform capitalization rules of section 263A apply to a virtual currency exchange?

A-21: Yes. Personal property acquired for resale includes both tangible and intangible property considered inventory for sale to customers in the ordinary course of business. Virtual currency is intangible personal property and a virtual currency exchange is subject to the rules of section 263A (other than for small taxpayers excepted from section 263A).

8. Traders and Dealers of Virtual Currency

Overview

Taxpayers considered dealers and traders who engage in buying and selling securities in the ordinary course of business to customers may make a "mark-to-market" election under section 475. This election recognizes ordinary gains or losses on the deemed sales involved in the mark-to-market process. The securities holdings on the last day of the year are deemed as sold for their fair market value resulting in both ordinary income and ordinary expenses the same as for any other trade or business. Taxpayers who trade virtual currencies perform this activity on virtual currency exchanges that contain all the robust trading features available on trading platforms for securities and commodities, including the same level of liquidity. In this context, virtual currencies are akin to securities and commodities. This particular issue is also under consideration by the Commodity Futures Trading Commission.[9]

Suggested FAQ

Q-22: May taxpayers who trade virtual currency elect the mark-to-market rules under section 475 if they otherwise qualify as a dealer or trader?

A-22: Yes. The nature of virtual currency trading is akin to dealers and traders of securities and commodities and a taxpayer may elect mark-to-market treatment. The taxpayer must otherwise qualify as a dealer or trader in order to make the election.

9. Treatment Under Section 1031

Overview

Section 4, Q&A-1 of Notice 2014-21 states that "general tax principles applicable to property transactions apply to transactions using virtual currency," which is guidance that is generally helpful in determining the tax consequences of most virtual currency transactions. Thus, section 1031 treatment should apply for exchanges entered into before 2018.

A holder of virtual currency who uses it to acquire a different virtual currency with only the two parties involved has engaged in a simultaneous swap. If the currencies are held for use in a business or for investment purposes and determined to meet the definition of like-kind, section 1031 applies to defer any realized gain or loss.

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[9] Testimony of Commissioner Mark Wetjen before the U.S. House Committee on Agriculture Subcommittee on Commodity Exchanges, Energy, and Credit Subcommittee, April 14, 2015: http://www.cftc.gov/PressRoom/SpeechesTestimony/opawetjen-12. Also, see Nermin Hajdarbegovic, "Commissioner Claims CFTC Can Intervene in Bitcoin Markets," CoinDesk, Nov. 18, 2014: http://www.coindesk.com/commissioner-claims-cftc-can-intervene-Bitcoin-markets/.

Suggested FAQ

Q-23: Does section 1031 apply to an exchange of virtual currency held for investment or business (other than dealer property)?[10]

A-23: Yes. Notice 2014-21 provides that virtual currency is treated as property. Thus, if the property is held for investment or business (not dealer property), and all requirements of section 1031 are satisfied, like-kind exchange treatment applies if the exchange occurs before 2018.

Note:
Taxpayers need guidance in order to properly interpret and apply the rules and regulations in this area. Guidance on the relevant factors to determine if two virtual currencies are like-kind is necessary, along with guidance on whether any of the existing section 1031 rules apply differently given the various types of virtual currencies, how they are held, and how taxpayers can transfer them.

10. Treatment Under Section 453

Overview

Notice 2014-21 provides that virtual currency is treated as property. Therefore, where a taxpayer disposes of virtual currency with at least one payment received after the close of the tax year of the disposition, the installment method of section 453 applies. The installment method would not apply if the currency is held as dealer property or inventory, or the owner elects not to have the method apply.

Suggested FAQ

Q-24: Does the installment method in section 453 apply to virtual currencies?

A-24: Yes. The installment method applies to virtual currencies that are not dealer property or inventory and requires reporting on Form 6252, *Installment Sale Income*. If the taxpayer elects out of the installment method treatment, this method would not apply.

11. Holding Virtual Currency in a Retirement Account

Overview

The prevalence of virtual currency as an investment vehicle leads to consideration of holding it in retirement funds.

[10] Public Law 115-97 (12/22/17), Sec. 13303, changes section 1031 to apply only to exchanges of real property, effective for exchanges completed after December 31, 2017. However, guidance is still required under section 1031 for virtual currency exchanges that occurred before the effective date of this change.

Suggested FAQ

Q-25: May taxpayers hold virtual currencies in an IRA or similar retirement savings account?
A-25: Yes. Virtual currency is considered property and taxpayers may hold it in an IRA if all other IRA requirements are satisfied.

Note:
Taxpayers need guidance on whether other types of retirement accounts, if any, can hold virtual currencies. The IRS should also provide guidance on what special documentation rules or requirements apply given the decentralized nature of virtual currencies and the various ways these currencies are held and transferred.

12. Foreign Reporting Requirements for Virtual Currency

Overview

Taxpayers need specific guidance on foreign reporting requirements for virtual currency. An IRS analyst for the Small Business/Self-Employed Division (SBSE) stated, in June of 2014, that virtual currency accounts were not reportable on the Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR), for tax years ended 2014.[11] However, no guidance was provided in regards to future tax years. Some virtual currencies are traded on centralized exchanges that operate in jurisdictions outside the United States. The exchanges are either a pure virtual currency exchange or a virtual currency exchange which allows virtual currencies to exchange into fiat currencies. These foreign virtual currency exchanges have custody of customers' virtual currencies and an exchange failure results in the loss of customer funds. In addition, taxpayers do not control their funds on a centralized exchange the same way they control funds in any other traditional financial institution. Both of the centralized exchanges mentioned above are similar to a Foreign Financial Institution (FFI) because they behave in the same manner. Therefore, taxpayers should report the value of virtual currencies and fiat currencies held at those exchanges if they meet the necessary threshold.

Conversely, when a taxpayer owns, controls and is in possession of a private key for a virtual currency wallet, they have 100% custody and control over all of the virtual currencies held in that wallet. If the taxpayer loses the private key, they lose all of their funds. This concept is akin to the taxpayer holding cash, gold, or any other asset in their personal possession. When the taxpayer owns, controls, and is in possession of the private key, the virtual currency resides in the country of the taxpayer's residence. In the case of a U.S. resident, the virtual currency by definition resides in the U.S. There is no Foreign Financial Institution (FFI) or financial institution of any kind because the taxpayers maintain possession similar to cash or gold. The same principles apply to both the FBAR and the Foreign Account Tax Compliance Act (FATCA).

[11] Rod Lundquist, a senior program analyst for the IRS Small Business/Self-Employed Division, stated on an IRS webinar that taxpayers did not have to report Bitcoin on the FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR), for the 2014 filing season.

Suggested FAQs

Q-26: Are taxpayers who hold virtual currencies and/or fiat currencies, on centralized virtual currency exchanges operating in a jurisdiction other than the U.S., required to report the value of the virtual currencies if the reporting threshold is met for both FBAR and FATCA compliance?

A-26: Yes. The value of virtual currencies should aggregate with fiat currencies and any other assets required for reporting under both FBAR and FATCA if their respective reporting thresholds are met.

Q-27: Are virtual currency wallets where taxpayers own, control, and are in possession of private keys for their own virtual currency wallets considered a Foreign Financial Institution for purposes of both FBAR and FATCA compliance?

A-27: No. Virtual currency wallets are owned and controlled by the taxpayer when in possession of the private key for that particular wallet. In this case, the virtual currency is considered cash which resides wherever the taxpayer resides and is therefore not considered a Foreign Financial Institution or subject to either FBAR or FATCA compliance.

Note:

IRS and Treasury should provide guidance on whether virtual currency accounts may become reportable on the Form 114, *Report of Foreign Bank and Financial Accounts*, in future tax years. Guidance should also explain whether there are circumstances that may alter virtual currency accounts into foreign financial assets under section 6038D, and therefore require reporting on Form 8938, *Statement of Specified Foreign Financial Assets*. Additionally, guidance should provide whether additional reporting obligations exist under the FATCA or whether there are other requirements for money services businesses (MSB) that exchange virtual currency. For example, would the IRS consider this exchange a financial institution activity?

APPENDIX

A) Bitcoin as a Conduit for Selling Virtual Currency for USD (A Double Capital Gain Paradox):

There are over 1,600 types of virtual currencies. Only a small number of these virtual currencies, including Bitcoin (BTC), Ethereum (ETH), and Litecoin (LTC), are considered "base currencies." Buyers can use cash to purchase base currencies and sell these currencies in exchange for cash.

Most of the other types of virtual currencies available, however, are "altcoins," which are the alternative cryptocurrencies launched after the success of Bitcoin. Unlike base currencies, altcoins are not quoted in a domestic currency. Therefore, users cannot purchase altcoins directly with cash and must use trading pairs to exchange altcoins back into a base currency or another altcoin. A trading pair describes the available trade link between one type of cryptocurrency and another. For example, Bitcoin (BTC) and Ethereum (ETH), are trading pairs because owners can sell one directly for the other. Currency pairs are illustrated as: "BTC/ETH," a ratio of the three letter abbreviation of the currencies involved.

Most virtual currencies are not trading pairs. For example, when a taxpayer wants to sell NXT, a form of cryptocurrency, they must sell it on an exchange such as Poloniex for Bitcoin. Then, the taxpayer would send the Bitcoin to another exchange such as Coinbase to sell it for the USD (Poloniex et al are pure virtual currency exchanges with no fiat exchanges).[12]

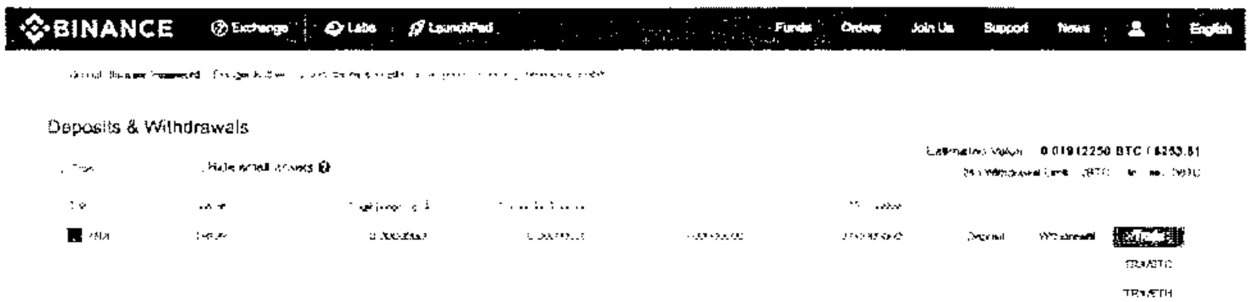
Bitcoin is required as a temporary conduit to facilitate the sale of NXT because there is no NXT/USD trading pair. If there was a direct NXT/USD trading pair, then the taxpayer would not need to use Bitcoin as the trading conduit.

> *Example A:*
> If a taxpayer sold $10,000 worth of NXT with a $1,000 basis, the taxpayer has a $9,000 gain. When Bitcoin is used as a conduit, the $10,000 worth of NXT is then sold for $10,000 of Bitcoin. If the taxpayer used FIFO and had a basis of $2,000 in the Bitcoin, then the sale of the $10,000 of Bitcoin results in an $8,000 gain when he/she sells the Bitcoin for USD. This transaction triggers a $9,000 gain for the sale of NXT and an $8,000 gain for the sale of Bitcoin, and thus a $17,000 total gain when the original sale proceeds were only $10,000.
>
> *Example B:*
> In Example A, if a taxpayer used specific identification, they could match the purchase of the Bitcoin (from the sale of NXT) to the sale of Bitcoin for USD at time zero, or in practical terms, within about an hour. The market fluctuation of Bitcoin in a one-hour

[12] Fiat money is currency that a government has declared as legal tender, but it is not backed by a physical commodity. The value of fiat money is derived from the relationship between supply and demand rather than the value of the material used to produce the money.

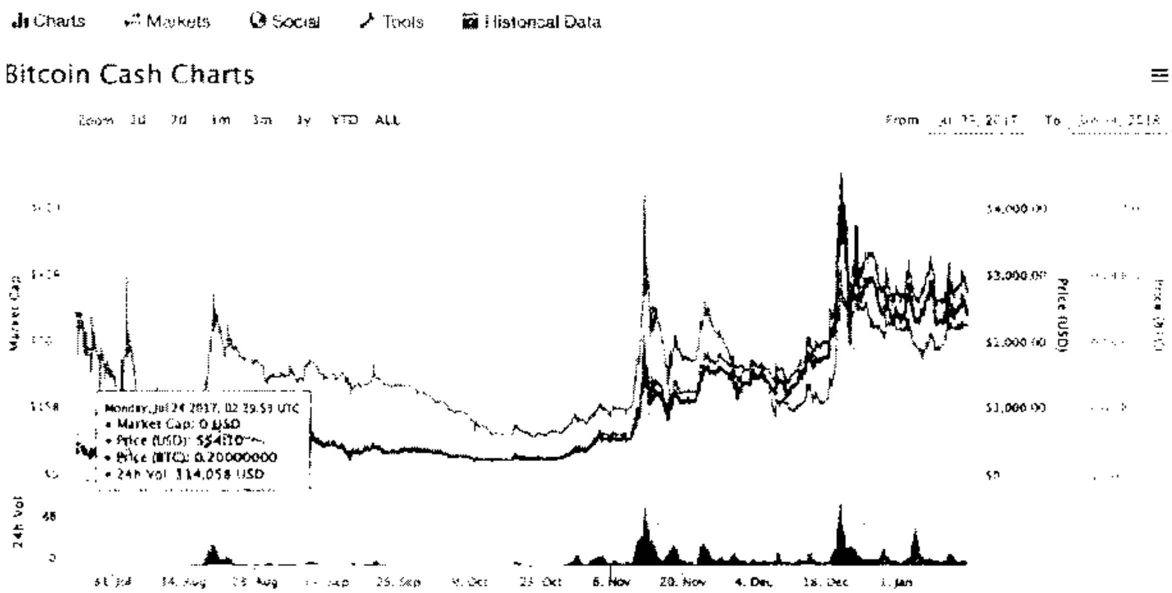
period would result in a gain of approximately $0 for Bitcoin instead of $8,000. The gain from the sale of NXT would remain as $9,000.

The Binance exchange screenshot below shows two trading pairs for TRON (TRX), a virtual currency. Users can only trade TRON on this exchange with Bitcoin (BTC) or Ethereum (ETH). A taxpayer seeking to trade TRX for USD currency would have to trade it for BTC or ETH, move the BTC or ETH to a different exchange, like Coinbase, and then sell the BTC or ETH for USD. This process results in two capital gains calculations with the possibility of a total gain larger than the original sales proceeds - the double capital gains paradox.



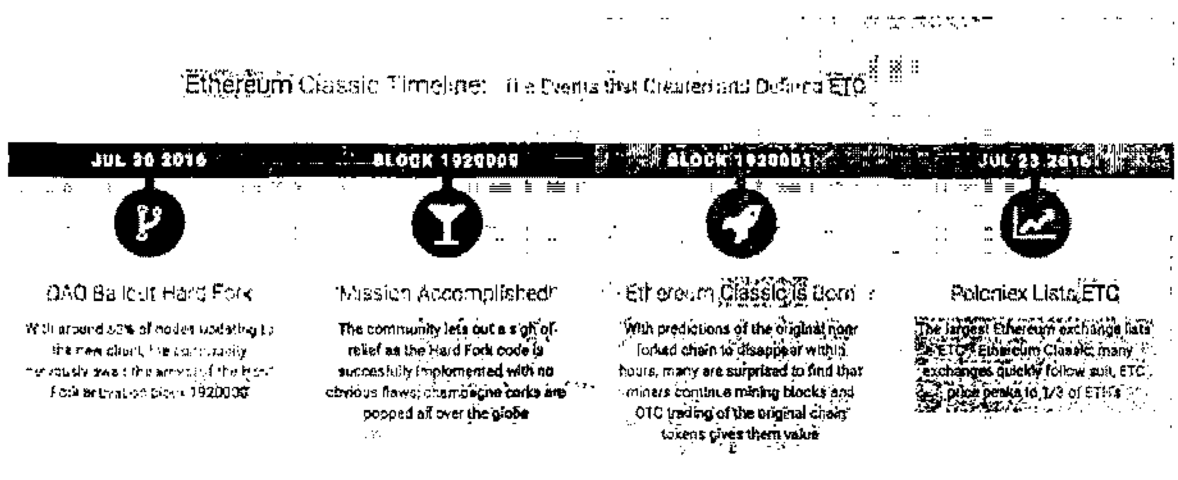
B) Bitcoin Cash (BCH) Price Discovery:

The Bitcoin blockchain forked on August 1, 2017. Per the screenshot below, price discovery occurred on July 24, 2017 because BCH was traded as a "futures token" prior to the actual chain split action. The price charts of the futures token and the actual BCH virtual currency post-August 1, 2017 split are combined as if the two tokens were one event. This process is not evident from the chart below unless you know the transactional history. Therefore, in this rare and unusual circumstance, a price discovery takes place near time zero. There are no reasonable and consistent applications to determine the time zero price discovery. Additionally, the creation of a new virtual currency, albeit related as kin to the original virtual currency, should have a zero basis. For additional information, see Bitcoin Cash Charts provided by CoinMarketCap at https://coinmarketcap.com/currencies/Bitcoin-cash/ (and provided below).

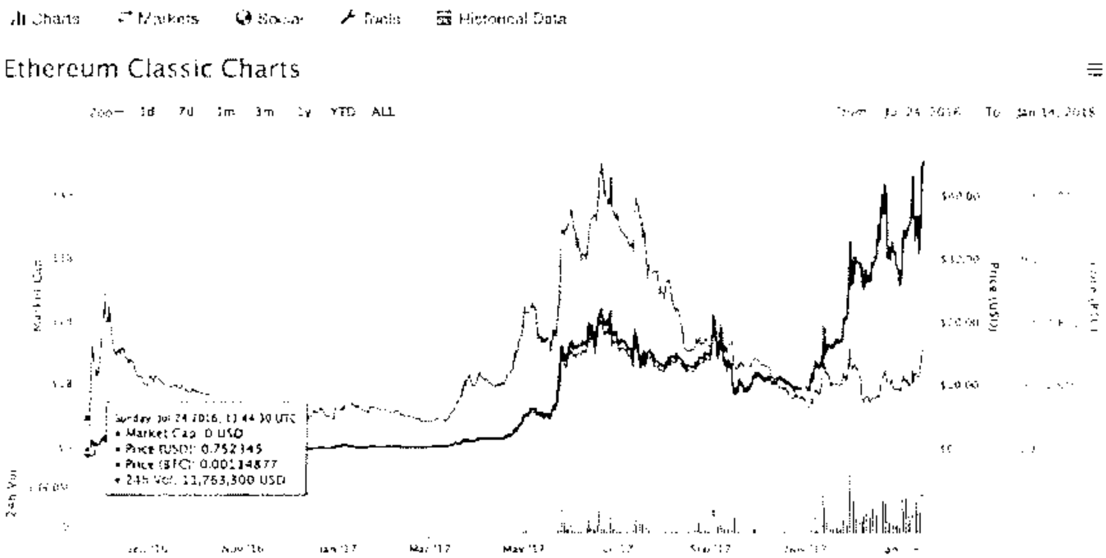


C) <u>Ethereum Classic (ETC) Chain Split Example:</u>

1. The Ethereum Community initiated a hard fork on 7-20-16 to solve the $55M DAO hack but unexpectedly some miners continued mining blocks of the original code resulting in a chain split into Ethereum (ETH) and <u>Ethereum Classic</u> (ETC) and two virtual currencies with ETC being the new virtual currency.



2. The Ethereum Classic (ETC) chart shows the first price discovery on 7-24-17 on Coinmarketcap, the most widely used cryptocurrency market capitalization website, which is four days after the chain split. In addition, ETC was listed on Poloniex, one of the most widely used virtual currency exchanges, on 7-23-17 three days after the chain split. Therefore, the price of ETC at the time of the chain split on 7-20-16 is zero because price discovery did not happen until at least 3 days later.



D) Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer:

The sample election below is based on list of requirements included in Treas. Reg. § 1.83-2(e). See Rev. Proc. 2012-29, page 9 for a sample election under section 83(b): https://www.irs.gov/pub/irs-drop/rp-12-29.pdf.

Election to Include a Virtual Currency Event as Ordinary Income in Year of Transfer

The undersigned taxpayer hereby elects, pursuant to [IRS Guidance on Virtual Currency], to include in ordinary income the fair market value of the virtual currency described below.

1. The name, taxpayer identification number, address of the undersigned, and the taxable year for which this election is being made are:

TAXPAYER'S NAME: ______________________
SOCIAL SECURITY NUMBER: ______________
ADDRESS: ______________________________
TAXABLE YEAR: Calendar Year 20__

2. The property which is the subject of this election is described below.

3. The property was transferred to the undersigned on [DATE].

4. The fair market value of the property at the time of the event is: $______.

5. For the property transferred, the undersigned paid $ _____.

6. The amount to include in ordinary income is $____________. [The result of the amount reported in Item 4 minus the amount reported in Item 5.]

The undersigned taxpayer will file this election with the Internal Revenue Service office with which taxpayer files his or her annual income tax return not later than 30 days after the date of transfer of the virtual currency event. The undersigned is the person with potential economic benefit in connection with the virtual currency event.

Dated: ____________________ Taxpayer: ____________________

Paul William M

From: Paul William M
Sent: Monday, July 22, 2019 3:05 PM
To: Desmond Michael J
Subject: FW: Thoughts re Crypto Guidance

Here's my email to Tom C. re crypto. Tom and I spoke on Friday and he said [redacted]

(b)(5) Deliberative Process Privilege

From: Paul William M
Sent: Thursday, July 18, 2019 9:53 AM
To: Cullinan Thomas A
Subject: Thoughts re Crypto Guidance

Tom,

FWIW:

(b)(5) Deliberative Process Privilege

[redacted]

Just some thoughts.

Bill

Paul William M

From: Wrobel Christopher
Sent: Wednesday, July 17, 2019 10:48 AM
To: Paul William M
Cc: Moriarty John P; Chyr Charlotte
Subject: RE: Crypto
Attachments: 20180530-aicpa-comment-letter-on-notice-2014-21-virtual-currency.pdf; AICPA (Troy Lewis).pdf; Creech.pdf; DWT LLP (LaVerne Woods).pdf; F&A (Adam Finesilver).docx; Letter - 2019-11771 (2).pdf; RF (Dmitriy Malinovskiy).pdf

Bill,

Following is a list of the most common cryptocurrency topics about which we have received requests for guidance. I also have included comment letters that address these topics, including letters from the ABA, AICPA, and California Lawyers Association, as well as a Congressional we received this past April. We received over 200 comments on the 2014 notice, most of which address the same topics set forth below, so I only have attached the major substantive letters. Please let me know if you would like to discuss.

(b)(5) Deliberative Process Privilege

[redacted]

Chris

From: Paul William M
Sent: Wednesday, July 17, 2019 9:18 AM
To: Wrobel Christopher
Cc: Moriarty John P; Chyr Charlotte
Subject: Crypto

Chris,

I've gone back and looked at the 2014 notice again and it answers some 16 questions relating to the taxation of virtual currency. The new rev rul adds some guidance but maybe not a whole lot to the answers provided in 2014. I know people are criticizing us for not issuing more guidance. [redacted] (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

Thanks.

Bill

Office of Information and Regulatory Affairs (OIRA)
Executive Order Submissions Under Review
July 17, 2019

Department of the Treasury

AGENCY: TREAS-CUSTOMS | RIN: 1515-AE26 | Status: Pending Review
TITLE: Enforcement of Copyrights and the Digital Millennium Copyright Act
STAGE: Proposed Rule | ECONOMICALLY SIGNIFICANT: No
RECEIVED DATE: 06/25/2019 | LEGAL DEADLINE: Statutory

AGENCY: TREAS-IRS | RIN: 1545-BP07 | Status: Pending Review
TITLE: Guidance regarding the determination of built in gains and losses [TCJA]
STAGE: Proposed Rule | ECONOMICALLY SIGNIFICANT: No
RECEIVED DATE: 04/11/2019 | LEGAL DEADLINE: None

AGENCY: TREAS-IRS | RIN: 1545-[illegible] | Status: Pending Review
TITLE: Guidance on New Section 451(c) [TCJA]
STAGE: Proposed Rule | ECONOMICALLY SIGNIFICANT: No
RECEIVED DATE: 04/12/2019 | LEGAL DEADLINE: None

AGENCY: TREAS-IRS | RIN: 1545-[illegible] | Status: Pending Review
TITLE: Section 451(b) Requirements [TCJA]
STAGE: Proposed Rule | ECONOMICALLY SIGNIFICANT: No
RECEIVED DATE: [illegible]/2019 | LEGAL DEADLINE: None

Note: "[TCJA]" indicates a Tax Cuts and Jobs Act (Pub. L. 115-97) regulatory action.

Cryptx

Notice 2014-21

SECTION 1. PURPOSE

This notice describes how existing general tax principles apply to transactions using virtual currency. The notice provides this guidance in the form of answers to frequently asked questions.

SECTION 2. BACKGROUND

The Internal Revenue Service (IRS) is aware that "virtual currency" may be used to pay for goods or services, or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. For a more comprehensive description of convertible virtual currencies to date, see Financial Crimes Enforcement Network (FinCEN) *Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (FIN-2013-G001, March 18, 2013).

SECTION 3. SCOPE

In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. This notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term "virtual currency" as used in Section 4 refers only to convertible virtual currency. No inference should be drawn with respect to virtual currencies not described in this notice.

The Treasury Department and the IRS recognize that there may be other questions regarding the tax consequences of virtual currency not addressed in this notice that warrant consideration. Therefore, the Treasury Department and the IRS request comments from the public regarding other types or aspects of virtual currency transactions that should be addressed in future guidance.

Comments should be addressed to:

coincodex

Why Cryptocurrency Taxation Is Taxing?

a day ago | Aaron Watts

Standardization of the way in which cryptocurrencies are taxed might be some way off, though the IRS's recent announcement that it will soon issue guidance on the matter moves another piece on the chessboard at least.

Questions have long been raised over federal taxation of bitcoin, with well-defined tax guidelines thus far remaining elusive. Furthermore, while the IRS has sought criminal prosecution for U.S. residents deemed to have failed to report income tax pertaining to virtual currency transactions, the regulations are notoriously ambiguous – not just stateside but globally.

Regardless of whether the tax agency in your country is pursuing you for crypto-specific back taxes, it pays to keep abreast of developments in this domain to ensure that investment opportunities and blockchain holdings can be properly evaluated and accounted for. If doing crypto taxes is within your forte, more power to you; just know that you are in the minority. Most hodlers would rather entrust crypto tax matters to an authority that can remove much of the guesswork, not least for the peace of mind this bestows.

Tax is taxing

Determining your annual tax is a complicated enough task, but a slew of factors make the process even more baffling where crypto is concerned. From non-existent or clashing laws to ridiculous red tape and opaque guidelines, it can be a Kafkaesque nightmare trying to cover your own back. After all, it's not like cryptocurrency exchanges hand out a 1099-B at year-end. Unless you employ a professional accountancy company well versed in crypto, you're on your own.

IRS Commissioner Charles Rettig's recent suggestion that the agency intends to issue clearer guidance concerning cryptocurrency taxation in the near future was met with skepticism in the crypto sphere. While improved clarification can only be a good thing, it remains to be seen whether the commissioner's promise comes to pass.

There are, of course, a number of nations where cryptocurrency investment gains are untaxed – and it is up to the governments of those nations to conceive and implement their own regulations, tailored to their own economies. Countries where bitcoin transactions are currently exempted from tax – at least to some degree – include Germany, Portugal, Malta, Belarus, Switzerland, Singapore and Malaysia. Interestingly, there are also regions wherein you can actually pay tax on cryptocurrency, including two Ontario, Canada municipalities – Innisfil and Richmond Hill. The cryptocurrency payment platform Coinberry is working in tandem with the regional authorities to supply the necessary tech.

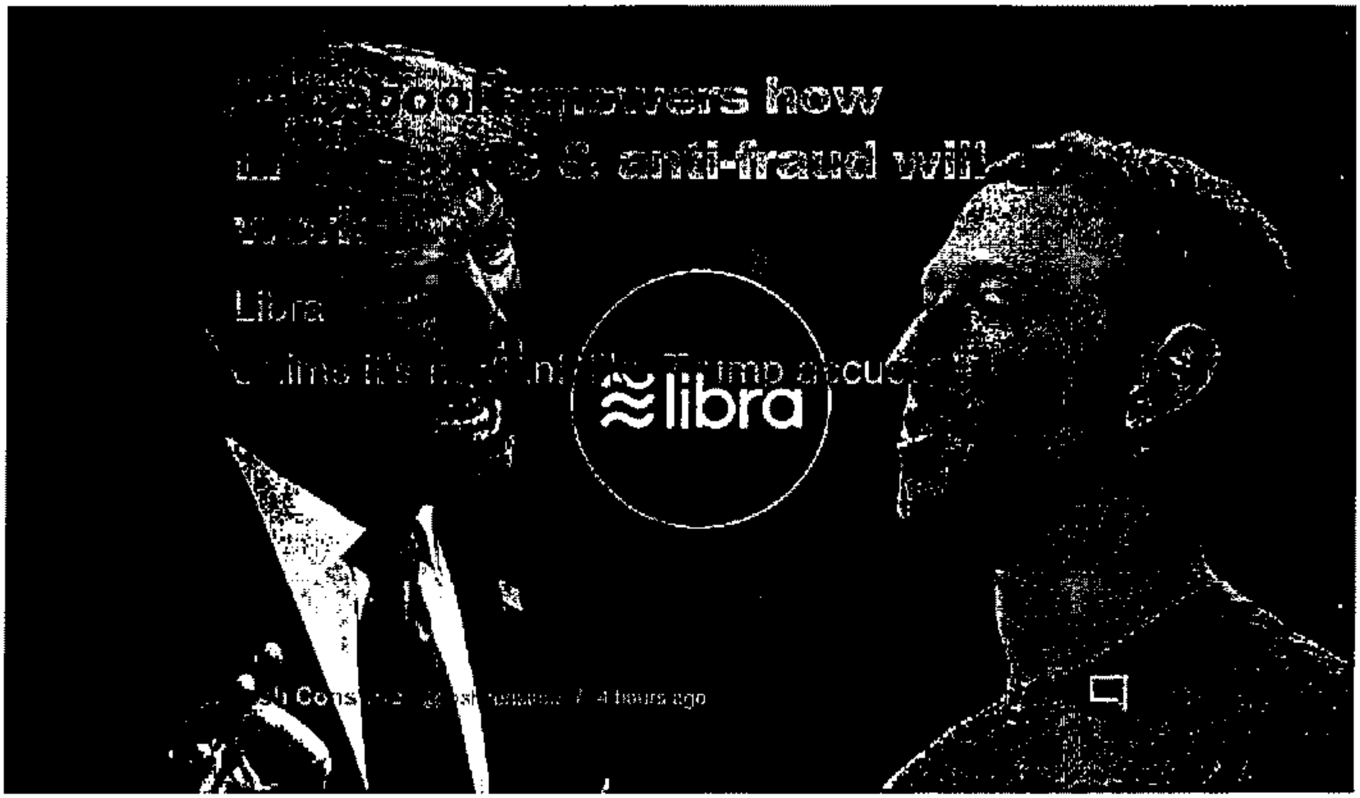
Questions that swirl around the taxation of cryptocurrency holdings are made all the more complex given the fluidity and ease of crypto transactions, and to what degree one owns, buys or trades digital assets and in which territories. Complicating matters further is the possibility of lost transaction data engendered by the mothballing of exchanges, usually due to liquidity issues. Even if your exchange is solid as a rock doesn't preclude the possibility of losing access to your account and consequently your record of historic transactions.

The shifting status of cryptocurrency

Ambiguity has been a watchword of crypto taxation since Bitcoin's inception. At present, crypto-assets come under capital gains tax in the United States, meaning each time an asset such as BTC are transacted, it is considered a taxable event. Or to put it another way, one must file each and every executed crypto transaction, treating it much the same as a property investment.

Accounting for tax across multiple cryptocurrency platforms is a challenge, both for citizens and for tax agencies pursuing evasion. With any luck, the tax obligations of crypto traders will become clearer in the near future, making life easier for everyone.

Tags: IRS Regulation Tax



Facebook provided TechCrunch with new information on how its cryptocurrency will stay legal amidst allegations from President Trump that Libra could facilitate "unlawful behavior." Facebook and Libra Association executives tell me they expect Libra will incur sales tax and capital gains taxes. They confirmed that Facebook is also in talks with local convenience stores and money exchanges to ensure anti-laundering checks are applied when people cash-in or cash-out Libra for traditional currency, and to let you use a QR code to buy or sell Libra in person.

A Facebook spokesperson said the company wouldn't respond directly to Trump's tweets, but noted that the Libra association won't interact with consumers or operate as a bank, and that Libra is meant to be a complement to the existing financial system.

Trump had tweeted that "Unregulated Crypto Assets can facilitate unlawful behavior, including drug trade and other illegal activity. Similarly, Facebook Libra's 'virtual currency' will have little standing or dependability. If Facebook and other companies want to become a bank, they must seek a new Banking Charter and become subject to all Banking Regulations, just like other Banks, both National and International."

For a primer on how Libra works, watch our explainer video below or read our deep dive into everything you need to know:

In a wide-reaching series of interviews this week, the **Libra Association's** head of policy Dante Disparte, Facebook's head economist for blockchain Christian Catalini and Facebook's blockchain project subsidiary Calibra's VP of product Kevin Weil answered questions about regulation of Libra. Here's what we've learned (their answers were trimmed for clarity but not edited):

Would Facebook's Calibra Wallet launch elsewhere even if it's banned in the USA by regulators?

Calibra's Kevin Weil: We believe that creating a financial ecosystem that has significantly broader access where all it takes is a phone and lower transaction fees across the board is good for people. And we want to bring it to as many people around the world as we can. But as a custodial wallet we are regulated and will be compliant and we will only operate in markets where we're allowed.

Facebook's Libra cryptocurrency explained

We want that to be as many markets as possible. That's why we announced well in advance of actually launching a product — because we've been engaging with regulators. We're continuing to engage with regulators and we can help them understand the effort that we're taking to ma[...] that people are safe and also the value that accrues to the people in their countries when there's broader access to financial services with lower transaction fees across the board.

TC

TechCrunch: But what if you're banned in the U.S.?

Weil: I'm hesitant to give a blanket answer. But in general, we believe that Libra is positive for people and we want to launch as broadly as possible. The world where the U.S. does that I think would probably cause other regulatory regimes to also be concerned about it. I think that's very much a bridge that we'll cross when we get there. But so far we're having frank, open and honest discussions with regulators. Obviously, that continues next week with David's testimony. And I hope it doesn't come to that, because I think that Libra can do a lot of good for a lot of people.

TechCrunch's Analysis: The U.S. House subcommittee has already submitted a letter to Facebook requesting that it cease development of Libra and Calibra until regulators can better examine it and take action. It sounds like Facebook believes a U.S. ban on Libra/Calibra would cause a domino effect in other top markets, and therefore make it tough to rationalize still launching. That puts even more pressure on the outcome of July 16th and 17th's congressional hearings on Libra with the head of Facebook's head of Calibra, David Marcus.

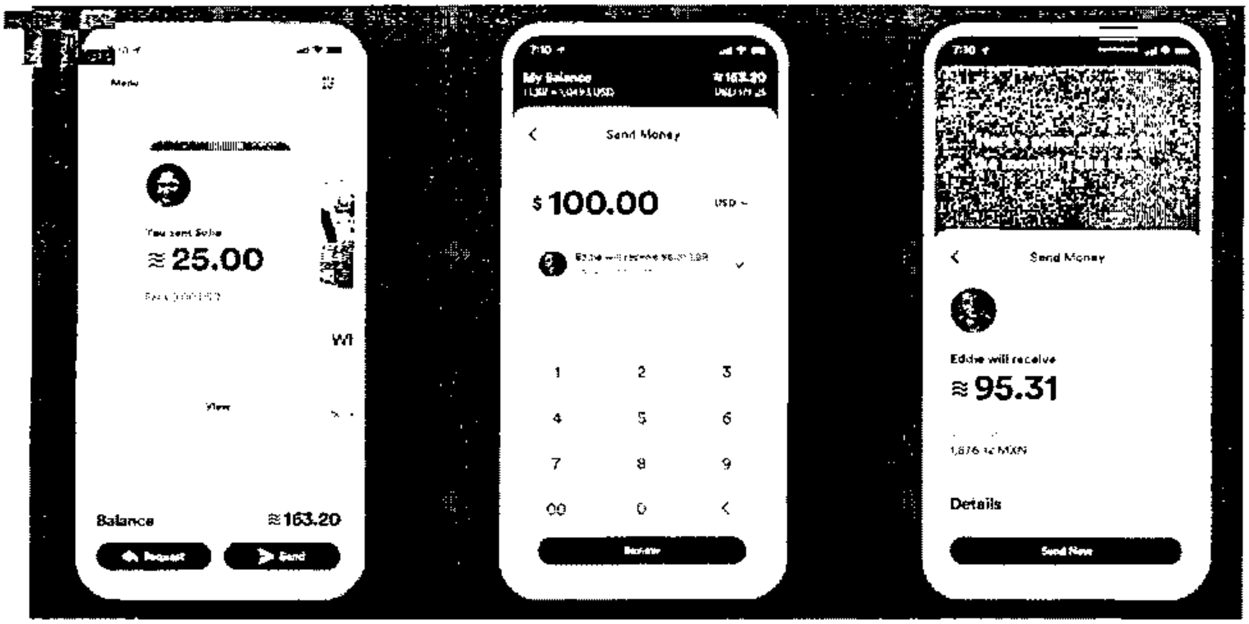
How will users cash-in and cash-out of Libra in person?

We already know that Facebook's own Libra wallet called Calibra will be baked into Messenger and WhatsApp plus have its own standalone app. There, those with connected bank accounts and government ID that go through a Know Your Customer (KYC) anti-fraud/laundering check will be able to buy and sell Libra. But a big goal of Libra is to bring the unbanked into the modern financial system. How does that work?

Weil: Because Libra is an open ecosystem, any money exchange business or entrepreneur can begin supporting cash-in/cash-out without needing any permission from anyone associated with the Libra Association or member of the Libra Association. They can just do it. Today in a lot of emerging markets [there's a service for matching you with someone to exchange cryptocurrency for cash or vice-versa called] LocalBitcoins.com and I think you'll see that with Libra too.

Second, we can augment that by by working with local exchanges, convenience stores and other cash-in/cash-out providers to make it easy from within Calibra. You could imagine an experience in the Calibra app or within Messenger or WhatsApp, where if you want to cash in or cash out, you'll pop up a map that highlights physical locations around that allow you to do it. You select one that's nearby, you select an amount, and you get a QR code that you can take to them and complete the transaction.

I'd imagine that most of these businesses that we work with will support Libra more broadly, so even if we get these deals started it will benefit the whole ecosystem and every Libra wallet, not just Calibra.



TechCrunch: Have you struck relationships with any convenience store operators or money exchangers like Western Union or MoneyGram, or Walgreens, CVS or 7-Eleven? Are you in talks with them yet?

Weil: I probably shouldn't comment on any specific deals but we're in conversation with a lot of the folks you might think, because ultimately being able to move between Libra and your local currency is critical to driving adoption and utility in the early days . . . If you're banked there are easier ways to do that. If you're not banked and you're in cash — those are the people we really want to serve with Libra — we're working very hard to make that process easy for people.

TechCrunch's analysis: This approach will let Calibra largely avoid the complicated and potentially error-prone process of KYCing people in person or handing out cash by offloading the responsibility and liability to other parties.

How will Libra stop fraud or laundering while offering access to unbanked users without ID?

Weil: There are very important populations that don't have an ID. People in a refugee camp may not, as an example, and we want Libra to serve them. So this is one example of many of why it's important that Calibra isn't the only option for people who want to participate in the Libra ecosystem . . . Others of these will be run by local providers and they have programs to meet customers face-to-face and other ways to serve people and even KYC them that we may not . . . We're not going be the only wallet, we don't want to be the only wallet.

This is one of the reasons NGOs have been members of the Libra association from the start, because we want to encourage the monetization of identity processes both through working with governments issuing credentials for more people and also making use of new types of information for identity and authentication. We hope this process will hep the last mile problem.

In the case of a non-custodial wallet, the user isn't trusting anyone. The way the regulations have worked and this is evolving as we speak. The on-ramps and off-ramps to the crypto world are regulated and they have direct customer relationships and it's their responsibility to KYC people. In our case we'll be a custodial wallet and we'll KYC people. There are a number of wallets in the Bitcoin or Ethereum ecosystem — non-custodial wallets that don't have a direct relationships with the users. . . They have to get that Bitcoin somehow. Usually they're going through an exchange where usually as part of the process they're KYC'd.

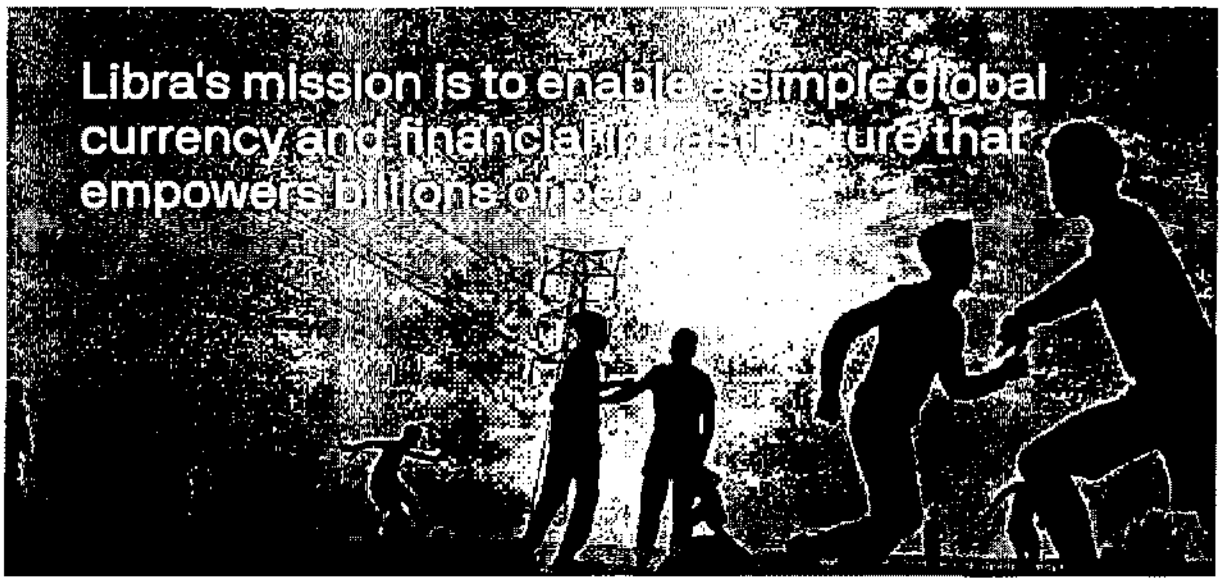
In a lot of emerging markets you have LocalBitcoins.com where you can find a representative or agent who will meet you in person and exchange cash for bitcoin in whatever market you have to be in. And I believe that they just started making sure that they KYC everyone, but they're doing it in person. And they have more flexibility in how they do it than you might otherwise. I think there are lots of ways that this will happen and the fact that Libra is an open ecosystem will enable people to be entrepreneurial about it.

There are lots an lots of people who are underserved by today's financial ecosystem who have government ID. So even with requiring everyone go through a KYC process, we'll be able to serve many, many people who are not well-served by today's financial ecosystem. We want to find ways to support people who can't KYC and the important part is that Calibra will fully interoperate with any other wallet, including ones that people in local markets are using because it's a better fit for their needs.

TechCrunch: Through that interoperability, if someone with a non-custodial wallet receives Libra and then sends it a Calibra wallet user, does that mean you Libra coming into Calibra from users who weren't KYC'd and could be laundering money?

Weil: So it's part of the regulatory situation that's evolving as we speak. There's something called the Travel Rule . . . If there's a transfer above a certain value you have to make sure that you understand both who the sender is, which you do if they're using a custodial wallet, and who the receiver is. These are evolving regulations, but it's something that obviously we're going to make sure that we implement as regulations solidify.

TechCrunch's Analysis: Calibra appears to be inviting regulation that it can strictly abide by rather than trying to guess at what the best approach is. But given it's unclear when concrete rules will be established for transfers between non-custodial wallets and custodial wallets, or for in-person cashing, Facebook and Calibra may need to establish their own strong protocols. Otherwise they could be guilty of permitting the "unlawful behavior" Trump describes.



How will Libra be taxed?

Dante Disparte of Libra: Taxing of digital assets is something that's being designed at the local level and at the jurisdiction level. Our view of the world is that like with any form of money or any form of payment or banking, the onus in terms of compliance with tax is with the individual user and consumer, and the same would hold true broadly here.

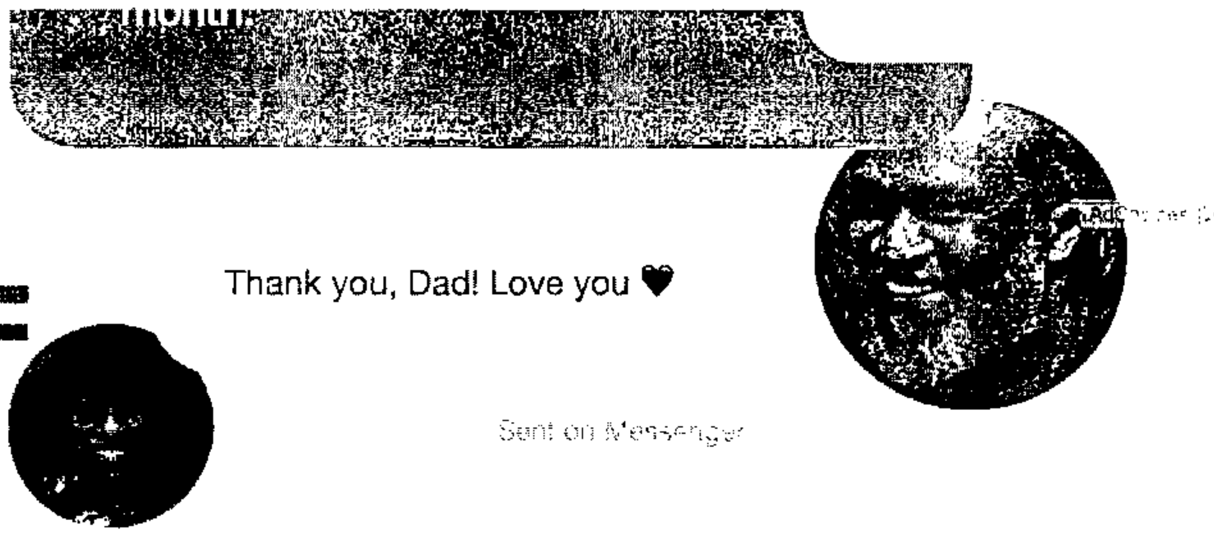
We expect that the many, many wallets and financial services providers building solutions on the Libra blockchain would begin to provide tools that make it much easier than it is today [to calculate and file taxes] for digital assets and cryptocurrencies more generally . . . There's plenty of time between now and Libra hitting the market to begin defining this more strictly at the jurisdictional level among providers.

TechCrunch's Analysis: Again, here Facebook, Calibra and the Libra Association are hoping to avoid shouldering all the responsibility for taxes. Their position is that just as you have to take the initiative of paying your taxes whether or not you use a Visa card or your bank's checks to transact, it's on you to pay your Libra taxes.

TechCrunch: Do you think in the United States that it's reasonable for the government to ask that Libra transactions be taxed?

Disparte: Tax treatments of digital assets broadly hasn't been entirely clarified in most places around the world. And we hope that this is something that this project and the ecosystem around it helps to clarify.

Tax authorities will see a benefit from Libra at the consumption level and at the household level, while some cryptocurrencies have avoided taxes until the point they tried to cash out. But the nature of it and the lack of speculation and its design we think should give it a light tax treatment the way you would find with traditional currencies.



Christian Catalini of Facebook: Cryptocurrencies are taxed right now every time you have a sale on the differences in gains and losses. Because Libra is designed to be a medium of exchange, those gains and losses are likely to be very tiny relative to your local currency . . . Sales tax would likely be implemented the exact same way on Libra as it is today when you pay with a credit card.

At launch giving current regulations, the Calibra wallet will have to track every purchase and sale of Libra for a U.S. user and those differences will have to be reported on tax day. You can think of the losses, albeit they may be very small gains and losses relative to USD, as similar to the what people do today when they have a Coinbase account with Bitcoin.

The sales tax I think could be implemented in the exact same way as it today with any other sort of digital payment, it would be no different. If you're buying goods or services with Libra you'll be paying sales tax the same way as if you used a different form of payment. Like today when you see a percentage, that is the sales tax on your total.

Defending Liberty
Pursuing Justice

TAXATION
A Section of the American Bar Association

Section of Taxation

Suite 400
1050 Connecticut Avenue, NW
Washington, DC 20036
202-662-8670
FAX: 202-662-8682
e-mail: tax@americanbar.org

March 19, 2018

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017

Dear Acting Commissioner Kautter:

Enclosed please find comments regarding the federal income tax treatment of cryptocurrency hard forks that have taken place in 2017 ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: Hon. William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Tax Legislative Counsel, Department of the Treasury
Rochelle Hodes, Associate Tax Legislative Counsel, Department of the Treasury
Drita Tonuzi, Deputy Chief Counsel (Operations), Internal Revenue Service
Scott Dinwiddie, Associate Chief Counsel (IT&A), Internal Revenue Service
Donna Welsh, Senior Technician Reviewer (IT&A, Branch 4), Internal Revenue Service
Kathryn Zuba, Associate Chief Counsel (PA), Internal Revenue Service
Helen Hubbard, Associate Chief Counsel (FIP), Internal Revenue Service
Karl Walli, Senior Counsel (Financial Products), Department of the Treasury

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
COMMENTS ON THE TAX TREATMENT OF HARD FORKS

The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Omri Marian, Vice Chair of the Section's Teaching Taxation Committee (the "Committee"), and Kerry Ryan, Chair of the Committee, had the principal responsibility for preparing these Comments. Substantive contributions were made by Adam Chodorow, James Creech, Elizabeth Crouse, Diane Ring, and Lisa Zarlenga. The Comments were reviewed by Lisa Zarlenga, Chair of the Section's Committee on Government Submissions.

Although some of the members of the Section who participated in preparing these Comments have clients who may be affected by the federal income tax principles addressed herein, no such member, or the firm or organization to which such member belongs, has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Omri Marian
(949) 824-6493
omarian@law.uci.edu

Kerry A. Ryan
(314) 977-7273
kerry.ryan@slu.edu

Date: March 19, 2018

Executive Summary

In 2014, the Internal Revenue Service (the "Service") issued Notice 2014-21 (the "2014 Notice"),[1] addressing the federal income tax treatment of "virtual currencies." The Section offered comments to the 2014 Notice in a letter dated March 24, 2015.[2] Since then, several important developments in the cryptocurrency[3] economy have taken place that are not addressed in the 2014 Notice. These developments raise important federal income tax questions, and we appreciate the opportunity to respond to the Service's request for comments on these issues.

An important issue, and the focus of these Comments, is the proper federal income tax treatment of a cryptocurrency hard fork ("Hard Fork"). A Hard Fork is a "change to the software of the digital currency that creates two separate versions of the blockchain with a shared history."[4] After a Hard Fork takes place, the original owner of the cryptocurrency retains its interest in the original coin and also has the right to use the forked coin. Hard Forks raise unique tax issues. Specifically, does a holder of a cryptocurrency that experiences a Hard Fork realize income for federal income tax purposes? If so, how much and when? The significant volatility in the exchange prices of cryptocurrency make valuation difficult and inconsistent among taxpayers.

As discussed further in these Comments, current law provides no clear answers to these questions. There are reasonable analogies to both taxable and nontaxable events. In light of the legal ambiguity, the significant valuation issues, and need for immediate guidance regarding the 2017 Hard Forks, the Section recommends that the Service consider issuing guidance that offers a temporary rule, in the form of a safe-harbor, to taxpayers who were able to transact in a forked currency as a result of a Hard Fork during the 2017 tax year. We recommend that such guidance prescribe the following:

1. Taxpayers who owned a coin that was subject to a Hard Fork in 2017 would be treated as having realized the forked coin resulting from the Hard Fork in a taxable event.

2. The deemed value of the forked coin at the time of the realization event would be zero, which would also be the taxpayer's basis in the forked coin.

[1] Notice 2014-21, 2014-16 I.R.B 938.

[2] https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032415comments.authcheckdam.pdf.

[3] These Comments also refer to virtual currency as "digital currency," "cryptocurrency," or "coins."

[4] David Farmer, *What is a Bitcoin fork?*, THE COINBASE BLOG (Jul. 27, 2017), https://blog.coinbase.com/what-is-a-bitcoin-fork-cba07fe73ef1.

3. The holding period in the forked coin would start on the day of the Hard Fork.

4. Taxpayers choosing the safe harbor treatment as set forth in the guidance would be required to disclose this on their tax returns.[5]

5. The Service would not assert that any taxpayer who availed themselves of the safe harbor treatment as set forth in the guidance has understated federal tax liability because of the receipt of a forked coin in a 2017 Hard Fork.

6. The Service, with input from the Section and other stakeholders, will continue to develop its position regarding the tax treatment for future Hard Forks, and such position may be different from the one noted above and will apply prospectively.

This temporary rule has the benefit of encouraging consistency among taxpayers with respect to 2017 Hard Forks, avoiding difficult timing and valuation issues (including the ability of taxpayers to benefit from hindsight depending on how the values fluctuated during 2017), and providing information to the Service regarding holders of the original and forked cryptocurrencies. Although the treatment may result in capital gain as opposed to ordinary income treatment, it preserves the full value of the forked coin for taxation when the taxpayer sells it. In addition, it restarts the holding period, thus resulting in sales occurring within a year being taxed as short-term capital gains.

The Section will continue to develop its position on the tax treatment of future Hard Forks and is considering other issues for comment in the cryptocurrency area. The Section looks forward to working with the Service on these issues.

[5] The guidance could provide for a simplified disclosure procedure for taxpayers who may already have filed a 2017 return, but who otherwise have taken a position consistent with the guidance with respect to Hard Forks.

I. Hard Forks in General

Cryptocurrencies are digital tokens, the ownership of which is recorded on a decentralized ledger. Cryptocurrencies are held in "wallets," which may be a type of hardware (*e.g.*, a device similar to a USB drive) or a type of software. Hardware wallets must be physically available to access certain security keys stored on the hardware that are required to control the disposition of the relevant cryptocurrency. Software wallets are just that: software stores the security keys that are required to control the disposition of the relevant cryptocurrency. Software wallets may be hosted in a variety of ways, including on the cloud, a desktop computer, or a mobile phone.

The security keys necessary to transfer cryptocurrency consist of a public key and a private key. Both are large strings of numbers that are mathematically linked to the wallet address. The private key is used to generate a "signature" for each blockchain transaction a user sends out. The private key is used to mathematically derive the public key, which is transformed with a hash function to produce the address that other people can see.

Cryptocurrencies generally may be traded for other cryptocurrencies or fiat currencies, for example the U.S. dollar, on exchanges that function much like stock exchanges. Cryptocurrency exchanges may also provide a software wallet in which users can store security keys for relevant cryptocurrencies. Trading on these platforms occurs in a manner analogous to trading in "street name" when an owner has an account with a large brokerage. That is, the exchange controls the owner's security keys and conducts batch trades for multiple users. This is a high-level description of how some intermediaries operate, though there are numerous variations.

Because the software that runs the ledger generally is open-source, and the network of computers that verify transactions generally operates via consensus, the software can be modified if enough participants on the network agree to do so. Hard Forks, sometimes also known as "Chain Splits" or "Coin Splits," are one example of such modifications. When a Hard Fork occurs, a new "branch" splits from the original ledger and is thereafter separately maintained. This means that the network of computers separates into subgroups, which separately verify transactions on the original ledger and the split or forked ledger. Those people whose ownership of a cryptocurrency was recorded on the original ledger maintain their ownership of the original cryptocurrency, but they are also entitled to claim ownership of the cryptocurrency maintained on the forked ledger. When an owner holds a cryptocurrency wallet directly (rather than through a custodial wallet), the owner does not actually receive anything new in a Hard Fork. Instead, the owner—once he or she has taken the necessary steps (as described below)—is able to use the same private key to transact on each of the ledgers. If the owner uses his or her private key to transact in the original cryptocurrency, the network participants verifying transactions on the original ledger will add it to that ledger, but the network participants verifying transactions on the forked ledger will not recognize it. This enables the owner to use his or her private key separately to transact in the forked coin and the original coin. The ownership history of both the original and forked cryptocurrency trace back to the same block on the blockchain, but going forward, the ledger of each cryptocurrency is independent (*i.e.*, they are not interchangeable).

It may be helpful to compare Hard Forks with "soft forks," which are more similar to a software upgrade. In a soft fork, the same blockchain is maintained (there is no split or branching), but some changes to the related software are made such that the blockchain functions somewhat differently after the soft fork. By analogy, a soft fork is more similar to the release of a new version of an existing variety of word processing software, for example, Microsoft Word. The new version typically recognizes documents created using the original version, but the original version may not recognize documents created using the new version unless the original software is updated.

There are many reasons for network participants to agree to Hard Forks. For example, one reason for Hard Forks is that users of the network agree that a fundamental upgrade to the ledger software is required. For example, on August 1, 2017, Bitcoin split into bitcoin (BTC) and bitcoin cash (BCH).[6] The purpose in creating BCH was to allow for a quicker generation of forked coins, as well as other improvements. Nonetheless, both BCH and BTC remain in existence, and both enjoy considerable trust of the cryptocurrency community. In contrast, some forks are a response to user mistrust in the original coin. For example, in 2016, the Ethereum blockchain was split into two in response to a hacking attack that affected the original ledger. In that case, the value of the original coin (Classic Ethereum) and the volume of trading in it plummeted due to the loss of user trust, while the forked coin (Ethereum), which is viewed more favorably by the market, essentially usurped the original coin. Even though original owners of Ethereum owned both the original and forked coins on the day of the split, the original coins became nearly worthless in comparison on that day (though both still trade and the original coin has since reached a greater price than it had prior to the fork).

In the case of a Hard Fork, an owner of the original coin must take active steps in order to transact in the forked coin. An owner that holds the original coin in a basic wallet (whether hardware or software), generally must download new software to a computer to use the forked coin. This requires some level of technological sophistication

[6] Other examples of Bitcoin chain splits include bitcoin gold in October 2017, bitcoin diamond in November 2017, and superbitcoin, bitcoin hot, and lightning bitcoin in December 2017.

and is inconvenient, but is not unduly burdensome for a reasonably experienced computer user. An owner that holds the original coin through certain other types of wallets is not required to download the software because the wallet service provider downloads the software, thus "supporting" the forked coin created in the Hard Fork. This is much easier for the average owner, but means that owners who use a custodial wallet service depend on the wallet service provider to permit them access to the forked coin.

For example, a few days before the BCH Hard Fork, Coinbase sent an e-mail to its customers stating that Coinbase has "no plans to support the Bitcoin Cash fork... Customers will not have access to, or be able to withdraw, bitcoin cash."[7] Only three days after the Hard Fork happened, Coinbase announced that it would support BCH, and would credit their customers' accounts accordingly.[8] Similarly, Xapo announced that customers had until December 14, 2017 to transfer or convert their BCH to BTC, or they would automatically convert it.[9] Many owners and wallet service providers take no action to claim the forked currency until the security risks have been sufficiently evaluated and mitigated. Nonetheless, it is generally possible for an owner to transfer the original coin from one wallet that will not support a Hard Fork and into another wallet that will support the Hard Fork prior to the occurrence of the Hard Fork. In that manner, the owner generally should be able to go through the processes necessary to claim the forked coin, at least if the owner is aware that a Hard Fork is going to occur.

II. Potential Tax Treatments of Hard Forks

Hard Forks raise the question of whether owners of an original coin who become entitled to use a forked coin by reason of a Hard Fork, realize income. We believe reasonable arguments may be made both ways because Hard Forks may be analogized to existing taxable and nontaxable events.

A. Hard Fork as a Realization Event

The Supreme Court in *Commissioner v. Glenshaw Glass*[10] liberally construed the term "gross income" as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion," reflecting Congress' intent to tax

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[7] David Farmer, *Update for customers with bitcoin stored on Coinbase*, THE COINBASE BLOG (Jul. 27, 2017), https://blog.coinbase.com/update-for-customers-with-bitcoin-stored-on-coinbase-99c2d4790a53.

[8] David Farmer, *Update of Bitcoin Cash*, THE COINBASE BLOG (Aug. 3. 2017), https://blog.coinbase.com/update-on-bitcoin-cash-8a67a7e8dbdf.

[9] Xapo Bitcoin Cash Update, https://support.xapo.com/xapo-bitcoin-cash-update.

[10] 348 U.S. 426, 431 (1955).

all gains except those specifically exempted. One could argue that the ability to use the forked coin in addition to the original coin represents such an accession to wealth.

In *Eisner v. Macomber*, the Supreme Court considered whether a pro-rata stock dividend paid to a common shareholder by a corporation with one class of stock constituted income. In holding that it did not, the Court distinguished taxable "gain derived from capital" from unrealized and therefore nontaxable—"gain accruing to capital or a growth or increment of value in the investment."[11] The pro-rata stock dividend in *Macomber* fell into the latter category because it was simply an additional piece of paper evidencing the increased worth of the taxpayer's original investment in the company—the shareholder has received nothing out of the corporation's assets for his use and benefit, and the corporation has not experienced a change in its aggregate assets or its outstanding liabilities.[12] In contrast, the Court defined a taxable "gain derived from capital" as "something of exchangeable value proceeding from the property, severed from the capital . . . and received or drawn by the [taxpayer] for his separate use, benefit and disposal."[13]

In *Macomber*, the receipt of additional stock was a consequence of owning the original stock, and the same could be said for forked coins, such as BCH, received in a Hard Fork. However, unlike in *Macomber*, BCH has unique properties, and it is unrelated to BTC except by the shared historical ownership. Thus, unlike the taxpayer in *Macomber*, one could argue that an owner of BTC who received BCH at the time of the fork received a new and different asset of exchangeable value for the owner's separate use rather than something representing an increase in the underlying value of the previously held BTC.

The regulations under section 1001[14] define a realized gain or loss as, *inter alia*, one from "the exchange of property for other property differing materially in either kind or extent."[15] The Supreme Court in *Cottage Savings Association v. Commissioner* defined materially different properties as those where "their respective possessors enjoy legal entitlements that are different in kind or extent."[16] Although there was not an exchange of BTC for BCH at the time of the Hard Fork, such that *Cottage Savings* is not precisely on point, the definition is useful in determining whether a holder of BTC at the

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[11] 252 U.S. 189, 207 (1920). This case involved a number of Constitutional issues that are not relevant here. Rather, we cite the case for the proposition that realization is an important element of income.

[12] *Id.* at 210-11.

[13] *Id.* at 207.

[14] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

[15] Reg. § 1.1001-1(a).

[16] 499 U.S. 554, 555 (1991).

Hard Fork received something materially different than the previously held BTC. One might argue that the upgrade reflected in the forked cryptocurrency represents a significant change in the protocol that mattered to users (otherwise the fork would not have been permanent), thus representing a material change. Although the forked cryptocurrencies share a pre-split transaction history, a Hard Fork represents a permanent split in the blockchain. Thereafter, transactions on the original blockchain are valid only in BTC, but invalid in BCH, and vice versa. In addition, BTC and BCH are traded separately, each with its own value.

Based on the above authorities, we believe a reasonable argument can be made that the receipt of a forked coin resulting from a Hard Fork constitutes a realization event.[17] However, even if one accepts such a view, there remains ambiguity as to *when* the realization occurs, and what is the *amount* realized.

Timing of realization

As mentioned above, the Supreme Court in *Commissioner v. Glenshaw Glass* defined taxable income as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[18] It is the last part of this definition—complete dominion—that raises an issue as to the timing of realization with regard to Hard Forks.

One possible argument is that realization happens at the time of the Hard Fork. At that point, an owner of the original coin becomes (at least in theory) unconditionally eligible to claim the forked coin, and he or she therefore must include the value of the forked coin at that time. However, when an owner holds an original coin in an account maintained by an intermediary such as Coinbase, the timing of realization becomes murky. In that case, a financial intermediary—whether the owner's agent or not—is preventing the owner from controlling the forked coin, which arguably may prevent the owner from experiencing a realization event.[19] On the other hand, cryptocurrencies are virtual currency and can be transferred to other intermediaries or the owner relatively easily and quickly. Consequently, it can be argued that the owner has voluntarily failed

[17] Other possible analogies to taxable transactions include dividends of property (§§ 301, 316), found property or treasure trove (Reg. § 1.61-14(a); *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969)), awards (*Hornung v. Commissioner*, 47 T.C. 428 (1967)), or free samples (*Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975)).

[18] 348 U.S. at 431.

[19] *See, e.g., Maryland Casualty v. U.S.*, 251 U.S. 342 (1920). Even if the owner does not hold an original coin through a third-party wallet, he or she may still take no action to claim the forked currency until the security risks have been sufficiently evaluated and mitigated.

to meet the conditions under which the forked coin can be claimed and is in constructive receipt of it.[20]

Amount Realized

Assuming realization, one must determine the amount realized, meaning, the value of the forked coin when realization occurs. Given the complexities in the cryptocurrency market, valuation is as much a problem of administrability and predictability as it is of consistency with existing U.S. federal income tax law.

After a Hard Fork occurs, there is a process of market price discovery. However, this process often takes place on multiple exchanges that do not "talk" to each other. As a consequence, the same type of cryptocurrency—even established cryptocurrencies such as BTC—may have different values on different exchanges at the same time. Thus, even though market values for a forked coin may emerge quickly (though, in some cases, a market may fail to materialize), the same coin may have different market values on different exchanges even within the same country at any point in time. Nonetheless, at the moment that a Hard Fork occurs—the first moment at which an owner of the original coin may obtain an interest in the forked coin—the forked coin arguably has no market value because it has not been previously traded and it is not clear whether a market will emerge for the coin.

We note that in some instances (such as in the case of BCH), an exchange may permit futures contracts in a forked coin to be traded before a Hard Fork occurs. However, to the best of our knowledge, no such websites constitute an "established market"—a concept to which many provisions in the Code refer as a method for determining market price—and therefore should not be used as a definitive source for determining the value of the underlying property (*i.e.*, the forked coin) for tax purposes.[21]

If one determines that realization occurs when an owner first has clear control over the forked coin resulting from a Hard Fork, then it is reasonable to argue that the fair market value of the forked coin must be determined at that time. It is reasonable to argue that in the case of third-party exchanges that also function as a wallet provider (*e.g.*, Coinbase), the amount realized would be the U.S. dollar value of the forked coin on that exchange at the time it is credited to an owner's account (*i.e.*, the first moment that the

[20] Reg. § 1.451-2. If the value of the forked currency is included in income immediately upon the fork, but the modifications to the blockchain are ultimately not adopted by participants on the network so that the fork is not permanent and the blockchain re-merges, the owner should arguably be able to take a loss equal to its adjusted basis in the forked currency. I.R.C. § 165(c)(2).

[21] *See, e.g.*, Reg. § 1.1273-2(f) (determining issue price for purposes of determining original issue discount).

intermediary elects to recognize the forked coin on behalf of the owner). As a result, the owner would report the fair market value of the coin at the time of crediting as ordinary income, since the forked coin was not received in a sale or exchange, and would take a basis in the forked coin equal to its fair market value at that time.

However, an owner who holds the forked coin through another wallet provider or technological method that recognizes the forked coin and credits it to an owner's account at the moment of the Hard Fork may include a very different amount in ordinary income due to the different timing of the realization event (*i.e.*, when the user obtained clear control over the forked coin). The owner may also be able to select the most favorable exchange rate by shopping the various exchanges. This is not necessarily a problem of fairness given that the owner has a choice regarding how he or she holds the original coin involved in the Hard Fork, but it is a problem of predictability and administrability (and an opportunity for taxpayers to attempt to game the U.S. federal income tax system).

B. Hard Fork as a Non-Realization Event

Given that a forked coin resulting from a Hard Fork shares transactional and ownership history with the original coin, one could also argue that the original coin has always included the future potential to create a forked coin. For example, one could argue that part of the potential of BTC has always been the creation of additional coins (such as BCH), and that such a possibility is capitalized into the market value of BTC. In other words, the forked coin is like the stock dividend in *Macomber* in that it simply represents part of the value of the original coin and therefor is more in the nature of a change in the form of ownership than a realization event. In this way, a Hard Fork is arguably similar to the birth of young from pregnant livestock, which generally has not been treated as a realization event.[22] Notably, the fact that BCH has modestly different properties from BTC should not be seen as conclusively establishing that a realization event has occurred; a calf has different properties from the cow that gives birth to the calf, and stock received in a nontaxable stock dividend need not be identical to the stock on which the dividend is paid.

If this position is accepted, the creation of BCH should not be treated as a realization event until the disposition of BCH by the owner (and taxed as a capital gain if the cryptocurrency is held as a capital asset). This position is supported by a reduction in

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[22] *See, e.g.*, *Metz v. United States*, 10 AFTR 2d 5443 (E.D. Ky. 1962); *Gamble v. Commissioner*, 68 T.C. 800 (1977); Rev. Rul. 86-24, 1986-1 C.B. 80. Other possible analogies to nontaxable transactions include the sale of minerals extracted (Reg. § 1.61-3(a)) or timber cut from land (*cf* I.R.C. § 631(a)), the partition of property (Reg. § 1.61-6(a)), or the severance of a joint tenancy (Rev. Rul. 56-437, 1956-2 C.B. 507).

price of BTC that happened at the time of the Hard Fork with BCH.[23] One could argue that the reduction of BTC value was attributable to the split with BCH, the value of which was no longer integrated with the value of BTC. It is difficult, however, to empirically prove that the prices of BTC and BCH are so associated due to the volatility of both currencies.

Alternatively, one may view the forked currency as not materially different than the original currency under the standard of *Cottage Savings*. The owner continues to use the same private key that permitted the owner to spend BTC prior to the Hard Fork to access BCH after the Hard Fork, and each are verified by a subset of the same network of computers. In addition, the ownership history of both BTC and BCH trace back to the same block on the blockchain; any changes emerge only going forward.

Even if one accepts the position that a Hard Fork is not a realization event, an important question remains. Specifically, one has to decide how to divide the basis between the original coin and the forked coin. One possible approach would be to adopt rules similar to those used in stock distributions, in which the basis is split based on the fair market value of the original and distributed stock.[24] However, in such a case, it will be necessary to determine the value of the forked coin at the time of the Hard Fork. As discussed above, there are real practical difficulties with determining the value of a forked coin.

III. PROPOSAL FOR 2017

The original intent of the Section was to fully develop the issues discussed herein. However, given that multiple Hard Forks took place in 2017, it is apparent that these issues are pressing and must be addressed in time to be of assistance for taxpayers during the current filing season. Therefore, the Section decided to leave the full development of these issues for later and instead proposes a temporary solution to apply only for the 2017 tax year.

Under the proposed temporary solution, we recommend that the Service issue guidance that offers a safe harbor to taxpayers who were able to transact in a forked coin as a result of a Hard Fork occurring during the 2017 tax year. Such safe harbor would prescribe the following:

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[23] Laura Shin, *Bitcoin Cash Skyrockets, Bitcoin Price Drops As Civil War Continues*, FORBES (Nov. 12, 2017), https://www.forbes.com/sites/laurashin/2017/11/12/bitcoin-cash-skyrockets-bitcoin-price-drops-as-civil-war-continues/#3968e99135b5.

[24] Reg. § 1.307-1.

1. Taxpayers who owned a coin that was subject to a Hard Fork in 2017 would be treated as having realized the forked coin resulting from the Hard Fork in a taxable event.

2. The deemed value of the forked coin at the time of the realization event would be zero, which would also be the taxpayer's basis in the forked coin.

3. The holding period in the forked coin would start on the day of the Hard Fork.

4. Taxpayers choosing the safe harbor treatment as set forth in the guidance would be required to disclose this on their tax returns.

5. The Service would not assert that any taxpayer who availed themselves of the safe harbor treatment as set forth in the guidance has understated federal tax liability because of the receipt of a forked coin in a 2017 Hard Fork.

6. The Service, with input from the Section and other stakeholders, will continue to develop its position regarding the tax treatment for future Hard Forks, and such position may be different from the one noted above and will apply prospectively.

While the Section has not concluded that this is the proper U.S. federal income tax treatment of Hard Forks, we believe that such temporary solution represents a reasonable interpretation of current law. In addition, we believe that the temporary solution imposes a reasonable administrative burden on the Service and compliance burden on taxpayers in this filing season, as it avoids difficult timing and valuation issues.[25] It also minimizes the ability of taxpayers to benefit from hindsight depending on how the values fluctuated during 2017. Finally, by requiring disclosure, the Service will obtain valuable information about cryptocurrency transactions and taxpayers participating in them.

We acknowledge that the temporary treatment may result in capital gain as opposed to ordinary income treatment (assuming the cryptocurrency is held as a capital asset), but by assigning a zero value, it preserves tax on the full value of the forked currency for taxation when the taxpayer sells it. In addition, this approach restarts the holding period, thus resulting in sales occurring within a year being taxed as short-term capital gains.

The Section will continue to refine its position and is happy to assist the Service in developing a permanent position regarding the tax treatment of Hard Forks. The

[25] We note that the Service has previously adopted safe harbors to avoid difficult valuation issues. *See, e.g.*, Rev. Proc. 93-27, 1993-2 C.B. 343, *clarified by* Rev. Proc. 2001-43, 2001-2 C.B. 191.

Section also plans to comment on other issues in the cryptocurrency area and looks forward to prioritizing and working with the Service on those issues.

IRS News Release

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07 | 25 | 19

IRS has begun sending letters to virtual currency owners advising them to pay back taxes, file amended returns; part of agency's larger efforts

IR-2019-132

WASHINGTON — The Internal Revenue Service has begun sending letters to taxpayers with virtual currency transactions that potentially failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions properly.

"Taxpayers should take these letters very seriously by reviewing their tax filings and when appropriate, amend past returns and pay back taxes, interest and penalties," said IRS Commissioner Chuck Rettig. "The IRS is expanding our efforts involving virtual currency, including increased use of data analytics. We are focused on enforcing the law and helping taxpayers fully understand and meet their obligations."

The IRS started sending the educational letters to taxpayers last week. By the end of August, more than 10,000 taxpayers will receive these letters. The names of these taxpayers were obtained through various ongoing IRS compliance efforts.

For taxpayers receiving an educational letter, there are three variations: Letter 6173, Letter 6174 or Letter 6174-A, all three versions strive to help taxpayers understand their tax and filing obligations and how to correct past errors.

Taxpayers are pointed to appropriate information on IRS.gov, including which forms and schedules to use and where to send them.

Last year the IRS announced a Virtual Currency Compliance campaign to address tax noncompliance related to the use of virtual currency through outreach and examinations of taxpayers. The IRS will remain actively engaged in addressing non-compliance related to virtual currency transactions through a variety of efforts, ranging from taxpayer education to audits to criminal investigations.

Virtual currency is an ongoing focus area for IRS Criminal Investigation.

IRS Notice 2014-21 states that virtual currency is property for federal tax purposes and provides guidance on how general federal tax principles apply to virtual currency transactions. Compliance efforts follow these general tax principles. The IRS will continue to consider and solicit taxpayer and practitioner feedback in education efforts and future guidance.

The IRS anticipates issuing additional legal guidance in this area in the near future

Taxpayers who do not properly report the income tax consequences of virtual currency transactions are, when appropriate, liable for tax, penalties and interest. In some cases, taxpayers could be subject to criminal prosecution.

More information on virtual currencies can be found on IRS.gov.

-30-

Paul William M

From: Paul William M
Sent: Thursday, July 18, 2019 9:53 AM
To: Cullinan Thomas A
Subject: Thoughts re Crypto Guidance

Tom,

FWIW:

(b)(5) Deliberative Process Privilege

[redacted]

Just some thoughts.

Bill

Crypto

I

116TH CONGRESS
1ST SESSION

H. R. 2144

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to exclude digital tokens from the definition of a security, to direct the Securities and Exchange Commission to enact certain regulatory changes regarding digital units secured through public key cryptography, to adjust taxation of virtual currencies held in individual retirement accounts, to create a tax exemption for exchanges of one virtual currency for another, to create a de minimis exemption from taxation for gains realized from the sale or exchange of virtual currency for other than cash, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

APRIL 9, 2019

Mr. DAVIDSON of Ohio (for himself, Mr. SOTO, Mr. GOTTHEIMER, Mr. BUDD, Ms. GABBARD, and Mr. PERRY) introduced the following bill; which was referred to the Committee on Financial Services, and in addition to the Committee on Ways and Means, for a period to be subsequently determined by the Speaker, in each case for consideration of such provisions as fall within the jurisdiction of the committee concerned

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A BILL

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to exclude digital tokens from the definition of a security, to direct the Securities and Exchange Commission to enact certain regulatory changes regarding digital units secured through public key cryptography, to adjust taxation of virtual currencies held in individual retirement accounts, to create a tax exemption for exchanges of one virtual currency for another, to create a de minimis exemption from taxation for gains realized from the sale or exchange of virtual currency for other than cash, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Token Taxonomy Act of 2019".

SEC. 2. SECURITIES ACT OF 1933.

(a) DEFINITION OF DIGITAL TOKEN.—Section 2(a) of the Securities Act of 1933 (15 U.S.C. 77b(a)) is amended by adding at the end the following:

"(20) DIGITAL TOKEN.—The term 'digital token' means a digital unit—

"(A) that is created—

"(i) in response to the verification or collection of proposed transactions;

"(ii) pursuant to rules for the digital unit's creation and supply that cannot be altered by any single person or persons under common control; or

"(iii) as an initial allocation of digital units that will otherwise be created in accordance with clause (i) or (ii);

"(B) that has a transaction history that—

"(i) is recorded in a distributed, digital ledger or digital data structure in which consensus is achieved through a mathematically verifiable process; and

"(ii) after consensus is reached, resists modification or tampering by any single person or group of persons under common control;

"(C) that is capable of being transferred between persons without an intermediate custodian; and

"(D) that is not a representation of a financial interest in a company or partnership, including an ownership interest or revenue share.

"(21) DIGITAL UNIT.—The term 'digital unit' means a representation of economic, proprietary, or access rights that is stored in a computer-readable format.".

(b) DEFINITION OF SECURITY.—Section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1)) is amended—

(1) by inserting "(A)" after "(1)"; and

(2) by adding at the end the following:

"(B) Such term does not include a digital token.".

(c) EXEMPTION.—Section 4(a) of the Securities Act of 1933 (15 U.S.C. 77d(a)) is amended by adding at the end the following:

"(8) Transactions involving the offer, promotion, or sale of a digital unit if—

"(A) the person offering, promoting, or selling the digital unit has a reasonable and good faith belief that such digital unit is a digital token; and

"(B) within ninety days following a written notification from the Commission to such person that such digital unit has been determined by the Commission to be a security, posts public notice of such notification and takes reasonable efforts to cease all sales and return all proceeds from any sales of such digital unit, excluding funds reasonably spent on the development of technology associated with the digital unit.".

(d) PREEMPTION OF STATE LAW.—Section 18 of the Securities Act of 1933 (15 U.S.C. 77r) is amended—

(1) by redesignating subsection (d) as subsection (e); and

(2) by inserting after subsection (c) the following:

"(d) DIGITAL TOKENS.—

"(1) IN GENERAL.—No law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof—

"(A) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a digital token;

"(B) shall directly or indirectly prohibit, limit, or impose any conditions upon the use of—

"(i) with respect to a digital token, any disclosure document concerning an offer or sale of a digital token that is prepared by or on behalf of a person developing, offering, or selling a digital token; or

"(ii) any proxy statement, report to digital token-holders, or other disclosure document relating to a digital token or a person developing, offering, or selling a digital token;

"(C) shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of a digital token offering or a person developing, offering, or selling a digital token, upon the offer or sale of any digital token; or

"(D) shall directly or indirectly require the filing of any notices or other documents, or the assessment of any fees, with respect to digital tokens or digital token transactions.

"(2) PRESERVATION OF FRAUD AUTHORITY.—States and political subdivisions thereof shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by any person, in connection with digital tokens or digital token transactions.".

SEC. 3. SECURITIES EXCHANGE ACT OF 1934.

(a) DEFINITION OF BANK.—Section 3(a)(6)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(6)(C)) is amended—

(1) by inserting "or trust company," after "Home Owners' Loan Act,"; and

(2) by striking "receiving deposits or exercising fiduciary powers" and inserting "receiving deposits, providing custodial services, or exercising fiduciary powers".

(b) DEFINITION OF SECURITY.—Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)) is amended—

(1) by inserting "(A)" after "(1)"; and

(2) by adding at the end the following:

"(B) Such term does not include a digital token.".

(c) DEFINITION OF DIGITAL TOKEN.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following:

"(82) DIGITAL TOKEN.—The term 'digital token' has the meaning given to it in section 2(a) of the Securities Act of 1933.".

(d) CLERICAL AMENDMENTS.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended—

(1) by moving paragraph (79) so as to appear after paragraph (78); and

(2) by redesignating the second paragraph (80) (relating to "Funding portal") as paragraph (81).

SEC. 4. INVESTMENT ADVISERS ACT OF 1940.

(a) DEFINITION OF DIGITAL TOKEN.—Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)) is amended—

(1) by redesignating the second paragraph (29) as paragraph (31); and

(2) by adding at the end the following:

"(32) The term 'digital token' has the meaning given to it in section 2(a) of the Securities Act of 1933.".

(b) DEFINITION OF SECURITY.—Section 202(a)(18) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(18)) is amended—

(1) by inserting "(A)" after "(18)"; and

(2) by adding at the end the following:

"(B) Such term does not include a digital token.".

(c) DEFINITION OF BANK.—Section 202(a)(2)(C) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(2)(C)) is amended by striking "receiving deposits or exercising fiduciary powers" and inserting "receiving deposits, providing custodial services, or exercising fiduciary powers".

SEC. 5. INVESTMENT COMPANY ACT OF 1940.

(a) DEFINITION OF DIGITAL TOKEN.—Section 202(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)) is amended by adding at the end the following:

"(55) The term 'digital token' has the meaning given to it in section 2(a) of the Securities Act of 1933.".

(b) DEFINITION OF SECURITY.—Section 202(a)(36) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(36)) is amended—

(1) by inserting "(A)" after "(36)"; and

(2) by adding at the end the following:

"(B) Such term does not include a digital token.".

(c) DEFINITION OF BANK.—Section 2(a)(5) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(5)) is amended by striking "receiving deposits or exercising fiduciary powers" and inserting "receiving deposits, providing custodial services, or exercising fiduciary powers".

SEC. 6. RULE OF CONSTRUCTION WITH RESPECT TO CFTC AND FTC.

Nothing in this Act or the amendments made by this Act shall be construed to limit the application of the Commodity Exchange Act or the Federal Trade Commission Act.

SEC. 7. SATISFACTORY CONTROL LOCATION REQUIREMENT.

Not later than 90 days after the date of the enactment of this Act, the Commission shall amend section 240.15c3–3 of title 17, Code of Federal Regulations, to provide that the requirement for a satisfactory control location for any digital unit (as defined under section 2(a) of the Securities Act of 1933) that is a security is fulfilled by protecting the digital unit using public key cryptography and by following commercially reasonable cybersecurity practices to maintain the privacy and accessibility of sufficient private key material to solely be able to sign on behalf of such digital unit.

SEC. 8. INDIVIDUAL RETIREMENT ACCOUNT INVESTMENTS IN CERTAIN VIRTUAL CURRENCIES NOT TREATED AS DISTRIBUTIONS.

(a) IN GENERAL.—Section 408(m) of the Internal Revenue Code of 1986 is amended—

(1) in paragraph (3)—

(A) in the heading of the paragraph, by striking "AND BULLION" and inserting ", BULLION, AND VIRTUAL CURRENCIES";

(B) in subparagraph (A)(iv), by striking "or";

(C) in subparagraph (B), by inserting "or" after "futures contract,";

(D) by inserting after subparagraph (B) the following:

"(C) virtual currency."; and

(E) by striking "if such bullion" and inserting "This paragraph shall only apply to bullion which"; and

(2) by adding at the end the following:

"(4) VIRTUAL CURRENCY DEFINED.—For purposes of this subsection, the term 'virtual currency' means a digital representation of value that is used as a medium of exchange and is not currency (within the meaning of section 988).".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to sales or exchanges on or after January 1, 2017.

SEC. 9. CERTAIN EXCHANGES OF VIRTUAL CURRENCY TREATED AS NON-TAXABLE EXCHANGES.

(a) IN GENERAL.—Section 1031 of the Internal Revenue Code of 1986 is amended—

(1) in the heading, by striking "**REAL PROPERTY**" and inserting "**CERTAIN PROPERTY**"; and

(2) in subsection (a), by adding at the end the follow new paragraph:

"(4) EXCHANGE OF VIRTUAL CURRENCY.—An exchange of virtual currency (as defined under section 408(m)) shall be treated as if such exchange were an exchange of real property under this section.".

(b) CLERICAL AMENDMENT.—The table of parts for part III of subchapter O of chapter 1 of such Code is amended by striking "Exchange of real property" and inserting "Exchange of certain property".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to exchanges made on or after January 1, 2017.

SEC. 10. GAIN FROM SALE OR EXCHANGE OF VIRTUAL CURRENCY.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1986 is amended by inserting after section 139F the following new section:

"SEC. 139G. GAIN FROM SALE OR EXCHANGE OF VIRTUAL CURRENCY.

"(a) IN GENERAL.—Gross income shall not include gain from the sale or exchange of virtual currency (as defined under section 408(m)) for other than cash or cash equivalents.

"(b) LIMITATION.—

"(1) IN GENERAL.—The amount of gain excluded from gross income under subsection (a) with respect to a sale or exchange of virtual currency shall not exceed $600.

"(2) AGGREGATION RULE.—For purposes of this subsection, all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange.

"(c) INFLATION ADJUSTMENT.—In the case of any taxable year beginning in a calendar year after 2018, the dollar amount in subsection (b) shall be increased by an amount equal to—

"(1) such dollar amount, multiplied by

"(2) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2017' for 'calendar year 2016' in subparagraph (a)(ii) thereof.

Any increase determined under the preceding sentence shall be rounded to the nearest multiple of $50.".

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 of such Code is amended by inserting after the item relating to section 139F the following new item:

"Sec. 139G. Gain from sale or exchange of virtual currency.".

(c) REPORTING OF GAINS OR LOSSES.—The Secretary of the Treasury shall issue regulations providing for information returns on transactions in virtual currency (as defined under section 408(m) of the Internal Revenue Code of 1986) for which gain or loss is recognized.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to transactions entered into on or after January 1, 2017.

WIKIPEDIA

Virtual currency law in the United States

United States virtual currency law is financial regulation as applied to transactions in virtual currency in the U.S. The Commodity Futures Trading Commission has regulated and may continue to regulate virtual currencies as commodities.[1][2] The Securities and Exchange Commission also requires registration of any virtual currency traded in the U.S. if it is classified as a *security* and of any trading platform that meets its definition of an exchange.[3]

The regulatory structure also includes tax regulations and FINCEN transparency regulations between financial exchanges and the individuals and corporations with whom they conduct business.

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The regulatory and market environment

The Internal Revenue Service (IRS) describes Virtual Currencies (VCs) as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value [and] does not have legal tender status in any jurisdiction." [4] Although electronic payment systems have been part of American life since at least 1871 when Western Union "introduced money transfer" through the telegraph[5] and in 1914 "introduced the first consumer charge-card", virtual currencies differ from these digital payment structures because unlike traditional digital transfers of value, virtual currencies do not represent a claim on value; rather the virtual currency are the value.

The National Automated Clearing House Association (NACHA), through the Automated Clearing House (ACH) moves almost $39 trillion and 22 billion electronic financial transactions each year.[6] These electronic transfers of money through the ACH Network represent a claim to physical legal tender. Alternatively, "unlike electronic money, a VC, particularly in its decentralised variant, does not represent a claim on the issuer."[7]

Electronic payment networks, such as the ACH, have decreased the costs and time required to transfer value and increased reliability and transparency. However, traditional electronic payment networks, even with transnational networks and satellite communications, differ from a virtual currency. For example, the Bitcoin exchange Coinbase charges only 1% on all Bitcoin exchanges to legal tender.[8] Compare this to "2%-4% for traditional online payment systems, like PayPal and credit card companies,[9] or a global average of 7.49% for remittance sent through major remittance corridors.[10] The lower costs of transferring value is a great incentive to both users and merchants. Faster transaction speed is also an advantage of using VC.[7] VC may also help to reduce identity theft because of the cryptographic nature of some of the currencies.[11]

Some experts predict various types of VCs will continue to increase, and the demand for the financial system to adopt methods of accepting these currencies will continue to grow. In 2011, Microsoft's Director of Corporate Affairs sent a letter to the Reserve Bank of Australia asking, "whether the domestic payments infrastructure could be modified or adjusted in some way to facilitate and manage the exchange of value beyond traditional currencies".[12] The online sale of goods and services in the United States accounted for an annual total of $283 billion transactions from the start of 3rd quarter 2013 to the end of 2nd quarter 2014 (adjusted for seasonal variation).[13] VCs are increasing as a percentage of these transactions. The Bitcoin exchange company Coinbase offers a payment service that allows merchants to receive Bitcoin and then automatically exchange the Bitcoin into fiat currency.[14] The speed of this exchange helps merchants to avoid the volatility of Bitcoin. In September 2014, eBay announced that its payment processor Braintree will be accepting Bitcoin.[15] As of November 2014, the market capitalization of Bitcoin is just below $5 billion, but has reached historic highs close to $14 billion.[16] The growth of Internet use and the virtual world is also increasing. World Internet use increased from 15.8% in 2005 to 38.1% in 2013.[17]

This Internet growth is characterized by a consumer demand for a decentralized Internet experience that is not limited or dependent on traditional institutions and governments. This movement aims to create an Internet based on the idea of Virtual, Distributed Parallel (VDP) States, "acting as a kind of organizational counterpoint to that State's governing bodies".[18] Crypto-currency and other virtual currencies are the VDP movements' currency alternative to traditional currency and traditional financial institutions.

Regulatory authority

The U.S. Congress has the power to regulate VCs as securities, through its power to coin money and prohibit private currencies,[19][20] and through its constitutional power to regulate insterstate commerce.[20] In a November 2014 decision, the Court upheld the power of regulators to prosecute a defendant who "designed, created and minted coins called 'Liberty Dollars,' coins 'in resemblance or in similitude' [or made to look like] of

U.S. coins."[21] Although the defendant did not pass the Liberty Dollars currency as a counterfeit, the currency were in close enough "resemblance of coins of the United States or of foreign countries" and consequently fell under the authority of 18 U.S.C.A. § 486.123 The Court has not decided if § 486 includes the power to prohibit VCs, but if a Court decides that the purpose and intent of VC resembles United States or foreign currency it may fall under § 486.

The Stamp Payment Act of 1862 prohibits anyone from "mak[ing], issu[ing], circulat[ing], or pay[ing] out any note, check, memorandum, token, or other obligation for a less sum than $1, intended to circulate as money or to be received or used in lieu of lawful money of the United States".[22] The Court has not decided if Congress has the power to prohibit VCs under this Act or any other existing regulation or statute.

Tax regulations

The IRS treats VC as property and requires for gains or losses upon an exchange of VC to be calculated.[4] This means that every VC user must track the gains or losses of every one of their VC transactions to stay in compliance with IRS regulations.[23] The Tax Foundation, a tax policy research organization, argues that the IRS got it wrong by categorizing VC as property because the required record keeping creates compliance obstacles, and by categorizing VC as property, the IRS is ignoring how VC is used and treating it as something that people hold for an investment.[24] The pseudonymity of VC accounts allow users to hide funds and evade taxes.[25] Similar to receiving cash, merchants may not report the earnings to the IRS if the merchant believes the IRS will not be able to account for the transaction. The IRS may be able to audit a VC exchange the merchant uses, but if the merchant is using a personal VC account or using multiple exchanges the IRS may not be able to track these transactions.

Electronic Fund Transfer Act

Virtual currencies lack many of the regulations and consumer protections that legal tender currencies have. Under U.S. law, a cardholder of a credit card is protected from liability in excess of $50 if the card was used for an unauthorized transaction.[26]

The Electronic Fund Transfer Act (EFTA) was written to protect consumers in transfers through ATMs, point-of-sale terminals, ACH systems, remote transfers, and remittance transfers. However, the EFTA does not apply to VCs, and due to the nature of many VCs, it may not be possible for VCs to be in complete compliance with the Act. For example, the regulations require for a consumer to be allowed 30 minutes to cancel an electronic transfer.[27] Many VCs, such as Bitcoin, do not allow chargebacks, so cancelling the Bitcoin transfer is not possible. Additionally, a credit card that transacts in VC is not protected by the fifty-dollar maximum liability for the holder of the credit card.[28]

FinCEN regulations

In 2013, the Financial Crimes Enforcement Network (FinCEN) released a paper stating exchanges and administrators of VC are subject to the Bank Secrecy Act (BSA) and must register as a Money Services Business (MSB).[29] The stated purpose of this legislation was to prevent financial exchanges from being used to launder money or finance crime, including terrorism.[30] The European Central Bank has also recommended registering exchanges to "reduce the incentive for terrorists, criminals and money launderers to make use of these virtual currency schemes for illegal purposes".[31]

Monetary policy

The current amount of VC use in the global market is unlikely to significantly affect the Federal Reserve's ability to conduct monetary policy; however, if the size of the VC market were to grow larger it may affect monetary policy.[32] Even with the impact VC could have on monetary policy, the Reserve does not have the authority to supervise or regulate VC.[33] According to May 9, 2014 meeting of the Federal Advisory Council and Board of Governors of the Federal Reserve, Bitcoin was deemed to "not present a threat to economic activity by disrupting traditional channels of commerce" but rather a potential "boon". Its global transmissibility opens new markets to merchants and service providers" and "capital flows from the developed to the developing world should increase".[34] In its 2009 Report to Congress, the U.S. Treasury claimed that the dollar will continue to be a major reserve currency "as long as the United States maintains sound macroeconomic policies and deep, liquid, and open financial markets".[35]

According to former CIA CTO Gus Hunt, the "Government's going to learn from Bitcoin, and all the official government currencies are going to become crypto currencies themselves".[36] Under 12 U.S. Code § 411, the Federal Reserve has the authority to issue Federal Reserve notes,[37] and under 12 U.S.C.A. § 418, the Treasury Department "in order to furnish suitable notes for circulation...shall cause plates and dies to be engraved" and print numbered quantities.[38] The Secretary of the Treasury has the authority to "mint and issue coins".[39] However, it is uncertain if this authority includes the authority to "mint" electronic coins for a government-backed cryptocurrency protocol. According to the Federal Reserve Bank of St. Louis's Director of Research, "the most important aspect of this technology revolution is, in my view, the threat of entry into the money and payment system and what I think it will do is to force traditional institutions, including central banks, to either adapt or die".[40]

Illegal activities with virtual currency

Money laundering

The culture of laundering money in the Bitcoin network is so prevalent there is even a website called bitlaunder.com. The company bitlaunder.com claims they are "experts at laundering Bitcoin" and they "use the most sophisticated methods available to completely anonymize your Bitcoins and obscure their history from forensic tracing".[41] The U.S. Government Accountability Office reported that the pseudonymity in VCs makes it difficult for the government to detect money laundering and other financial crimes, and it may be necessary to rely on international cooperation to address these crimes.[42] Similarly, the European Banking Authority claimed that regulations should strive for "global coordination, otherwise it will be difficult to achieve a successful regulatory regime".[7] In spite of the best regulations from the United States and the European Union, the inherent nature of the Bitcoin protocol allows for pseudonymous transfers of Bitcoins to or from anywhere in the world, so illegal transactions will not be completely eliminated through regulations.

Anonymity in Bitcoins and Altcoins (forks from the Bitcoin protocol) can be increased by adding software augmentations to the VC. Zerocoin, for example, uses an algorithmic process called "zero-knowledge proof" to hide the value of the coins.[43] Dark Wallet anonymously combines transfers of VC to obscure the origin of the transfer, and the developers intend to integrate the software into a Tor network in the future. One of the developers of Dark Wallet described it as "just money laundering software". He said, "I want a private means for black market transactions", "whether they're for non-prescribed medical inhalers, MDMA for drug enthusiasts, or weapons."[44] A crypto currency known as Darkcoin offers even more anonymity than Bitcoin. Similar to Dark Wallet, Darkcoin combines transactions to increase the difficulty of analyzing where the currency was sent. "Some users may be trading Bitcoins for Darkcoins and back again, using the Darkcoin network as a giant bitcoin-laundering service."[45]

Other forms of VC have also been used for making illegal transactions. The VC service and exchange Liberty Reserve allegedly laundered over 6 billions dollars from crimes such as "credit card fraud, identity theft, investment fraud, computer hacking, child pornography, and narcotics trafficking".[46] E-gold, a company with a VC tied to the value of gold, pleaded guilty to money laundering and running an unlicensed money transmitting business, and consequently had to forfeit $45,816,817.84 to the government.[47]

Although the Bank Secrecy Act (BSA) applies to VC exchanges and administrators, VC is still used to finance crime and launder money because not every transaction in VC networks are required to comply with the BSA and not every online exchange complies with the BSA. In September 2014, Robert M. Faiella, a/k/a "BTCKing", pleaded guilty to operating an unlicensed exchange that exchanged over a million in cash for Bitcoin, used for criminal enterprise and known as "Silk Road".[18] Despite BSA regulations, Faiella and the users of his exchange, were able to hide their identity through both pseudonymous Bitcoin addresses and an anonymous network that hid their IP addresses.[49]

Transactions on Tor

On November 2014, the FBI, "as part of a coordinated international law enforcement action", seized dozens of "dark markets", including Silk Road II operating on the anonymous Tor network. These markets accepted payment in Bitcoins or similar crypto-currencies, and operated both domestically and internationally.[50] Although the FBI was successful in cracking through the anonymous Tor network and discovering the origin of the illegal Bitcoin markets Silkroad I and II and similar illegal markets, the methods the FBI used may not be legal or available, in every case, under the U.S. Constitution's prohibition against unreasonable searches and seizures.

October 2014, the court decided the fate of the defendant regarding his role in the first Silkroad, but the court refused to decide whether his Fourth Amendment rights were violated because he never pleaded that he had a right to privacy in the server that was searched.[51] The Court claimed that the defendant did not plead a violation of his Fourth Amendment rights because either "he in fact has no personal privacy interest in the Icelandic server, or because he has made a tactical decision not to reveal that he does" thus claiming that Ulbricht "therefore has no basis to challenge".[51] This is significant because the Court did not decide if the techniques the FBI used to locate the defendant IP address violated the Fourth Amendment.

Operating behind the anonymous Tor network might give a subjective expectation of privacy, but this may not be reasonable expectation of privacy that would survive the *Katz* test[52] because the Tor software explicitly states that it "can't solve all anonymity problems".[53] Under *Warshak*, the defendant had a "reasonable expectation of privacy" in the content of his email; however, unlike an email, an IP address is generally visible to everyone.[54] The FBI claimed they found Silkroad's IP address by "typing in miscellaneous entries into the username, password, and CAPTCHA fields contained in the interface" to find an IP address associated with an application misconfigured to the Tor network.[55]

Securities fraud

The Securities and Exchange Commission (SEC) treats securities crimes committed with Bitcoin and VCs as money, and it is likely that anti-gambling regulations will be enforced with the same reasoning. On July 2013, Trendon T. Shavers was charged by the SEC for "defrauding investors in a Ponzi scheme involving Bitcoin" that amounted to over 700,000 Bitcoin or $4.5 million based on the average price of Bitcoin in 2011 and 2012 when the investments were offered and sold.[56] Shavers implemented the scheme through Bitcoin Savings and Trust (BTCST), "an unincorporated online investment scheme" that was not registered with the SEC.[57] "The collective loss to BTCST investors who suffered net losses (there were also net winners) was 265,678 bitcoins, or more than $149 million at current exchange rates" from September 2014.[57]

Shavers attempted to argue the investments were not securities because Bitcoin is not money. However, in a precedent determining decision, the magistrate judge determined that Bitcoin is money, and thus the investments were securities.[57] The magistrate judge stated, "[i]t is clear that Bitcoin can be used as money. It can be used to purchase goods or services, and as Shavers stated, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan. Therefore, Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money."[57] This decision paved the way for other regulators to treat Bitcoin and VCs as money, so it is likely this decision will be cited if regulators decide to prosecute VC transactions under the UIGEA, Illegal Gambling Business Act, Wire Act, or any other regulation involving financial transactions.

Consumer warnings

On August 2014, the Consumer Financial Protection Bureau (CFPB) released a consumer advisory to warn consumers of the risk of VCs. The advisory warned consumers of hackers, scammers, loss of VCs by losing the private key, fewer regulations, and an inability to make chargebacks.[34] States have also released consumer advisories and warned users that VCs are not insured by the FDIC, highly volatile, often associated with criminal enterprises, new, and unproven technology.[58][59][60] David S. Cohen, the Under Secretary for Terrorism and Financial Intelligence at the Treasury Department, stated that VCs pose "clear risks to consumers and investors" because the "anonymity and transaction irrevocability [of VCs] expose[s] them to fraud and theft, [a]nd unlike FDIC insured banks and credit unions that guarantee the safety of deposits, there are no such safeguards provided to virtual wallets".[61]

The result of this weak regulatory environment makes VCs prone to volatility, market manipulation, money laundering, fraud, and illegal transactions.[62] On August 11, 2014, the Consumer Financial Protection Bureau (CFPB) released a consumer advisory warning on VC and began accepting complaints on VC products and services.[32] Additionally, many U.S. states have released consumer warnings regarding virtual currencies.

Online gambling

The federal legality of online gambling with Bitcoins in the United States has not yet been decided; however, the legality of online gambling with legal tender currency has been decided. In April 2011, the FBI indicted the "founders of the three largest Internet poker companies doing business in the United States—PokerStars, Full Tilt Poker, and Absolute Poker...with bank fraud, money laundering, and illegal gambling".[63] In 2006, the United States enacted the Unlawful Internet Gambling Enforcement Act (UIGEA), yet the poker companies continued to operate until the 2011 indictment. Similar to the 2011 indictment, the Justice Department may be collecting evidence and building a case against the Bitcoin gambling sites before they launch an indictment. The UIGEA does not expressly prohibit Internet gambling, but it does make it illegal for an online gambling business to knowingly accept fund transfers.[64] The Bitcoin gambling sites are currently circumventing this legislation by keeping their funds in bitcoin cryptocurrency wallets. However, in order for these sites to exchange their Bitcoins for a fiat currency they must use a financial exchange, so even by receiving their earnings with Bitcoin, the online gambling sites may come into jurisdiction of the UIGEA if the gambling business accepts payment through "(i) automated clearing house (ACH) systems, (ii) card systems, (iii) check collection systems, (iv) money transmitting businesses, and (v) wire transfer systems."[65]

The Illegal Gambling Business Act may also prohibit Bitcoin gambling sites because the act broadly prohibits all gambling businesses that are in (i) "violation of the law of a State or political subdivision in which it is conducted; (ii) involves five or more persons who conduct, finance, manage, supervise, direct, or own all or part of such business; and (iii) has been or remains in substantially continuous operation for a period in excess of thirty days or has a gross revenue of $2,000 in any single day."[66] Under IRS regulations Bitcoin and other VCs are treated as property, so losses and gains must be calculated to determine the value of the virtual currency. If an online gambling business earned the value of at least $2,000 dollars in Bitcoin "in any single day", they may fall under this act.

The Federal Wire Act (Wire Act) prohibits "bets or wagers on any sporting event or contest".[67] Some Bitcoin gambling sites have a mixture of betting on sports and traditional casino games,[68] and it is conceivable the bets on sporting events could fall within the language of the Wire Act. The Wire Act expressly mentions "money or credit as a result of bets or wagers", and VCs may fall under the intent of the Wire Act because they operate as credits that can be redeemed or exchanged at VC exchanges, and they operate like money because they facilitate transactions.[69]

Some online wagers do not fit under the typical definition of gambling or a game of chance. The Commodity Futures Trading Commission (CFTC) refers to these as "Event Contracts". On December 2011, the CFTC ordered an online business to cease listing Political Events Contracts (i.e., betting on who will be elected) for trade, as it is contrary to the public interest.[70] The CFTC's jurisdiction is being tested by online businesses that accept virtual currency for event contracts. A website, accepting Bitcoin and other VCs, called predictious.com lists trades such as trying to call who will be elected, whether a celebrity will have a boy or girl child, or who will be the winner of a science competition.

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) does not insure VCs.

Federal Election Commission

In a May 2014 Advisory Opinion, the Federal Election Commission (FEC) decided that Bitcoin donations are permitted under FEC laws.[71] This decision will permit microdonations, and it may encourage more people to donate to campaigns. The decision may also encourage more people to attempt to hide their political donations behind the pseudonymity of Bitcoin.

See also

- Digital currency exchanger
- Exchange (organized market)
- Liberty Reserve
- Legality of bitcoin by country or territory

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The table below is a list of terms used by major domestic and foreign digital currency exchanges (DCE – a term coined in 2004), payment services providers (PSP – a term coined in the 1980s), fintech firms, distributed ledger analytics firms, academic institutions, states/countries and regulators. After researching the terminology used by other sources, [redacted]

(b)(5) Deliberative Process Privilege

Organization	Business Type	Term(s) Used	Source
Coinbase (operations in U.S. and 31 other countries)	DCE (digital currency exchange) / wallet hosting service / PSP / card service	Digital Currency Exchange / Cryptocurrency	Coinbase.com/about
Bittrix (based in U.S.)	DCE	Blockchain Trading Platform	Bittrix.com/about
Gemini (based in U.S.)	DCE / wallet hosting service	Digital Asset Exchange / Cryptocurrency	Gemini.com/about
Circle (based in U.S.)	DCE / wallet hosting service	Digital Asset / Cryptocurrency	Circle.com/en/about
Kraken (based in U.S.)	DCE / wallet hosting service	Digital Currency / Cryptocurrency	Kraken.com
itBit (based in U.S.)	DCE / OTC Exchange / Escrow Svcs./ Custody Svcs.	Crypto Asset	Itbit.com
Bitfinex (based in Hong Kong)	DCE / wallet hosting service	Digital Assets / Cryptocurrencies	Bitfinex.com
Binance (based in Malta)	Centralized Platform - DCE and wallet hosting service / Decentralized Platform - DCE	Crypto Asset / Cryptocurrency	Binance.com/en/about
Bithumb (based in South Korea)	DCE / card service	Cryptocurrency / Digital Finance	Btckorea.com
VirWoX (based in Austria)	VCE (virtual currency exchange)	Virtual Currency	VirWoX (Virtual World Exchange) started in 2004 as a virtual currency exchange. BTC, a cryptocurrency, was added in 2011 as a method to purchase virtual currencies.

BitPay (based in U.S.)	PSP	Bitcon	Bitpay.com
CoinPayments (based in Canada)	PSP	Cryptocurrency	Coinpayments.net
CoinGate (based in Lithuania)	PSP	Cryptocurrency	Coingate.com
SpectroCoin (based in UK)	PSP	Cryptocurrency	Spectrocoin.com
Bitcoin IRA (based in U.S.)	Self-directed IRA services	Cryptocurrency	Bitcoinira.com/about
Texas	U.S. State Gov't	Cryptocurrency	Supervisory Memorandum 1037
Illinois	U.S. State Gov't	Digital Currency	The specific language of Illinois' Transmitters of Money Act (TOMA) makes a distinction between virtual currency and cryptocurrency as different types of digital currency.
39 States	U.S. State Gov't	No mention of cryptocurrency or virtual currency in state MTL (money transmitter laws)	It is notable that states like AZ, NV, and WY have legislation recognized blockchain in business applications for supply chain, accounting, document certification, etc.
9 States	U.S. State Gov't	Creates some definition for virtual currency	These states included cryptocurrency under the term virtual currency with a number of them attempting to develop language to exclude virtual currencies such as rewards programs and video gaming currencies but makes efforts to include gambling virtual currencies that are not cryptocurrencies.
Japan	Foreign Gov't	Crypto Assets	The change from virtual currency to crypto assets was made on May 31, 2019, in the Payment Service Act (PSA) and Financial Instruments and Exchange Act (FIEA).
Cuba	Foreign Gov't	Cryptocurrency	
France	Foreign Gov't	Cryptocurrency / crypto asset / digital asset	France has four regulators that oversee crypto assets.

Germany	Foreign Gov't	Blockchain-based securities / Electronic securities / security tokens	Germany has three regulators that oversee crypto assets.
Italy	Foreign Gov't	Virtual Currency / Cryptocurrency	Italy has five regulators that oversee crypto assets.
Spain	Foreign Gov't	Cryptocurrency	Spain has four regulators that oversee crypto assets.
Poland	Foreign Gov't	Cryptocurrency	
European Banking Authority	Regulator	Crypto-assets	Monitors the impact of products and services, including crypto assets, on the financial system, and the suitability of the regulatory perimeter under EU law. https://eba.europa.eu/
European Commission	Regulator	Crypto-assets	The Commission is responsible for planning, preparing, and proposing legislation, including any on cryptocurrency. It also monitors the effectiveness of financial sector reforms and responds to emerging financial stability risks. https://ec.europa.eu/commission/index_en
European Insurance and Occupational Pensions Authority	Regulator	Crypto-assets	Monitors the developments of cryptocurrencies and initial coin offerings (ICOs) in the insurance sector. https://eiopa.europa.eu/
European Securities and Markets Authority	Regulator	Crypto-assets	Responsible for safeguarding the stability of the EU's financial system. https://www.esma.europa.eu/
H.R. 528, H.R. 2144, H.R. 6973	U.S. Congressional legislation (introduced)	Virtual Currency / Digital Assets / Digital Token	Three House bills in the 116th Congress introducing legislation on digital assets.
FATF	IGO	Virtual Asset / Crypto Asset / virtual-to-virtual /	FATF 2019 Guide conflates terms from the cryptocurrency sector and the virtual currency

		Cryptocurrency / Virtual Currency	sector. FATF defines virtual assets but not crypto-assets. Uses terms like digital assets and crypto-precious metal dealers. But then uses terms like virtual currency, digital currency, and cryptocurrency as though they can all do the same thing through cryptographic protocols, which only cryptocurrencies can call cryptographic protocols. The guidance states everything is a virtual assets excluding virtual fiat currencies, virtual securities, and other financial assets covered by the FATF recommendations.
OFAC	U.S. Treasury Bureau	Virtual Currency	Various public statements
FinCEN	U.S. Treasury Bureau	Virtual Currency	FIN-2019-G001
IRS	U.S. Treasury Bureau	Virtual Currency	Notice 2014-21
SEC & CFTC	U.S. Commission	In the past used Virtual Currency, but in the last year uses terms like Digital Assets and Cryptocurrency	Letters and notices released to the public.
Chainalysis	Distributed Ledger Analytics / Forensics	Cryptocurrency / Cryptocurrency Exchange /	Chainalysis.com
Elliptic	Distributed Ledger Analytics / Forensics	Cryptocurrency / blockchain technology	Elliptic.co (not an error)
CypherTrace	Distributed Ledger Analytics / Forensics	Cryptocurrency / blockchain analytics / cryptocurrency intelligence / cryptocurrency forensics	Ciphertrace.com

MIT	Academic Institution	Cryptocurrency / Digital Currency / blockchain	The MIT Media Lab's DCI is a (https://dci.mit.edu/about-1) collaborats with other universities and research institutions, and works with interdisciplinary groups of faculty, students, and research scientists to author research papers, run pilot use cases of the technology, and develop relevant open-source software. MIT also has a cryptoeconomics program.
Cornell	Academic Institution	Blockchain / Cryptocurrency	http://courses.cornell.edu/preview_course_nopop.php?catoid=31&coid=499386 ; http://courses.cornell.edu/preview_course_nopop.php?catoid=31&coid=499386 ; Cornell's Initiative for Cryptocurrencies and Contracts (IC3)
State University of New York	Academic Institution	Cryptocurrency / Blockchain	https://blog.suny.edu/2018/06/a-new-online-learning-series-will-teach-you-about-blockchain-the-future-of-the-internet/
UC Berkeley	Academic Institution	Cryptocurrency/ Blockchain	https://www.edx.org/professional-certificate/uc-berkeleyx-blockchain-fundamentals
Stanford	Academic Institution	Cryptocurrency / Blockchain / Digital Asset	https://cs251crypto.stanford.edu/18au-cs251/

IRS Pushes for Virtual Currency Transaction Tax Compliance

POSTED ON JUL. 29, 2019

By

WILLIAM HOFFMAN
Contact Author

Further legal guidance on virtual currency transactions could soon be issued as part of the IRS's ramped-up efforts to encourage taxpayers to report transactions and pay the resulting taxes.

In the meantime, more than 10,000 taxpayers will receive letters from the IRS between now and the end of August reminding them that taxes must be paid on their virtual currency transactions, the tax agency said in a statement July 26.

"Taxpayers should take these letters very seriously," IRS Commissioner Charles Rettig said in the statement, which notes that data analytics and information gleaned from ongoing compliance efforts are being used to obtain taxpayer names. The Criminal Investigation division is also focusing on virtual currencies.

The IRS started sending the educational letters in mid-July, according to the statement. Recipients will get one of three letters (6173, 6174, or 6174-A), titled "Reporting Virtual Currency Transactions" and containing instructions on what errors need to be corrected on their forms and when and where to file them.

Notice 2014-21, 2014-16 IRB 938, declared that virtual currencies would be treated as property for federal tax purposes. While that 2014 notice provided some guidance, the American Institute of CPAs last year asked the IRS for another notice and FAQ to resolve issues including fair market valuation and valuations for cryptocurrency donations.

The IRS in 2018 launched a virtual currency compliance campaign of outreach and examinations.

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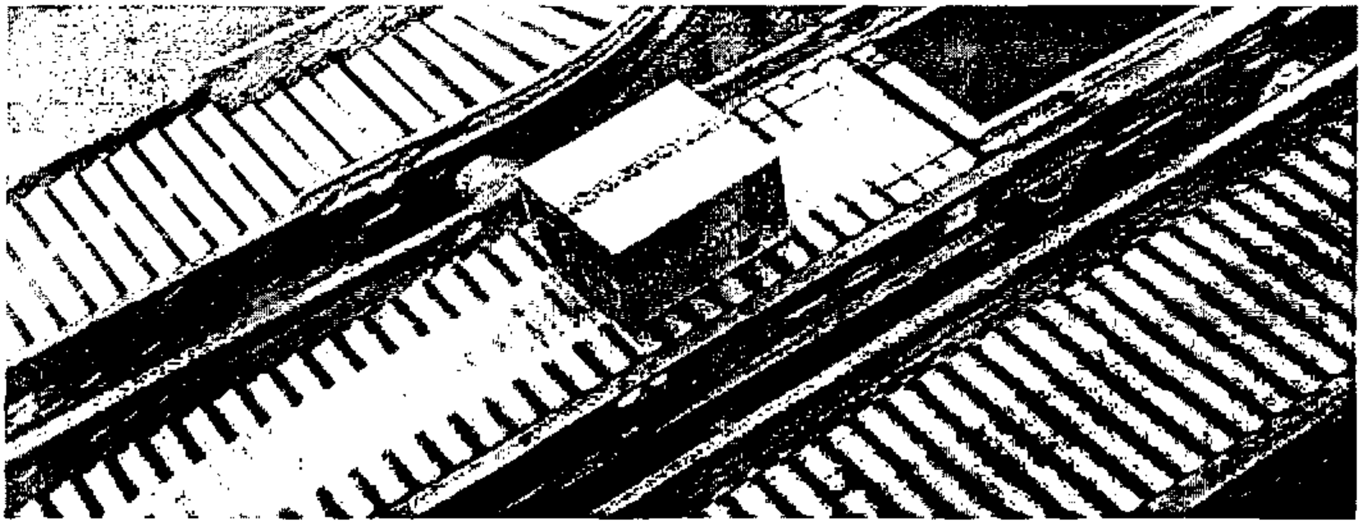

A package moves along a conveyor belt at the Overstock.com Inc. fulfillment center in Salt Lake City. Online marketplaces like Overstock that allow customers to make purchases with virtual currency may have to collect sales tax in many states.

Photographer: Daniel Acker/Bloomberg via Getty Images

More States Add Cryptocurrency Twist to Marketplace Sales Tax Laws

By Ryan Prete

Aug. 08, 2019 4:46AM

- *At least 16 states put tax collection duties on online marketplaces that accept virtual currencies*
- *It's unlikely states that don't are missing out on significant revenue: Tax executive*

Online marketplaces that allow or plan to allow customers to make purchases with virtual currency may unknowingly be setting themselves up to collect sales tax in more than a dozen states.

At least 16 states have a special provision in their marketplace facilitator laws that put marketplaces on the hook for sales tax collection if the business provides the option to pay with virtual currency to customers, according to Bloomberg Tax data. Marketplace facilitator laws require businesses like Amazon.com Inc. and Etsy Inc. to collect and remit sales and use tax on behalf of their vendors if they cross a specific threshold in the state. An example of such a currency could be Facebook's newly announced Libra cryptocurrency. Another is "credits" that can be purchased with cash and then used to buy upgrades and merchandise within video games through systems like Microsoft Corp.'s Xbox or

Sony Corp.'s PlayStation consoles, according to Mark Nebergall, president of the Software Finance & Tax Executives Council.

Alabama, California, Idaho, Iowa, Massachusetts, Nevada, New Jersey, North Dakota, Ohio, Kentucky, Rhode Island, Utah, Vermont, Virginia, Washington, and West Virginia currently have provisions that classify a marketplace facilitator as an entity that provides "a virtual currency that buyers are allowed or required to use in order to purchase products from the vendor."

States could be planning for the day a marketplace giant say Amazon or eBay Inc.- -introduces a virtual currency of its own. However, so far, the virtual currency provision is not a moneymaker, according to Nebergall.

"I'm not sure if states without the provision are missing out on potential revenue," he said. "It would be very hard to tell. If it happens they are, it isn't much."

Cryptocurrency is still in its infancy. It isn't regulated by the federal government, and it isn't used ubiquitously. However, some marketplaces such as Overstock.com allow purchases to be made with Bitcoin—arguably the most well-known form of cryptocurrency.

States sprung at the chance to tax marketplace facilitators after the U.S. Supreme Court's June 2018 ruling in *South Dakota v. Wayfair* tossed out its 1992 physical presence standard affirmed in *Quill Corp. v. North Dakota* that limited the ability of states to tax remote sales. The majority in the 5-4 ruling suggested strongly that South Dakota's law would pass constitutional muster.

Since the ruling, dozens of states have adopted a marketplace facilitator law.

Following Washington

Richard Cram, director of the Multistate Tax Commission's National Nexus Program, said states with the cryptocurrency provision might have just copied Washington, the first state to draft a marketplace facilitator law back in 2017.

"Many states borrowed their bill language from Washington, a state that has a broad definition of what constitutes a marketplace facilitator," Cram said. "All other states likely follow a narrow definition."

If a company's sole purpose was providing a virtual currency for use, then they wouldn't be classified as a marketplace facilitator in states that use a narrow definition, according to Cram.

"Washington most likely thought or thinks that virtual currencies are going to eventually be a hot trend and wanted to get ahead of the game," Cram said. "So far the trend hasn't materialized as quickly as folks thought."

Amazon, eBay, and Etsy didn't immediately respond to requests for comment.

To contact the reporter on this story: Ryan Prete in Washington at rprete@bloombergtax.com

To contact the editor responsible for this story: Jeff Harrington at jharrington@bloombergtax.com

Crypto

You Didn't Pay U.K. Tax on Big Crypto Gains—Own Up to It

By Hamza Ali

Aug. 14, 2019 2:26AM

- *Tax authority eyeing big gains of 2017-19*
- *Exchanges asked to turn over trader information*

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You Didn't Pay U.K. Tax on Big Crypto Gains—Own Up to It

By Hamza Ali 2019-08-14T02:26:29000-04:00

- *Tax authority eyeing big gains of 2017-19*
- *Exchanges asked to turn over trader information*

The U.K. is looking for cryptocurrency traders who made gains during the two-year crypto boom and didn't pay their taxes.

But it may not to be too late to avoid hefty penalties if traders disclose their gains without being prompted, tax advisers say.

HMRC is seeking data for the period April 2017 to April 2019, during the height of the market, when cryptocurrency traders made enormous profits.

The agency recently sent requests to exchanges asking for names of clients who live in the U.K., as well as the date and value transferred either in fiat or cryptocurrency for that period, according to Peter Ivanov, a spokesman at the CEX.IO exchange.

The government push for access to information held by exchanges is the first hint of a crackdown on traders who didn't pay taxes on their gains.

"HMRC regularly gathers data from a range of information sources using powers provided by Parliament. Data collected by HMRC is used to improve the integrity of the tax system and to identify those that have failed to declare their gains," a spokesperson for the agency said Aug. 12.

Some traders made significant gains in 2017 when the price of Bitcoin, one of the most popular cryptocurrencies, grew from roughly $1,000 to $20,000 a token.

"Many investors believe the misnomers that you don't have to report and that they can't touch you, but that's not the case, especially if you understand blockchain as a technology," said Shukry Haleemdeen, director of MyCryptoTax, a cryptocurrency tax advising firm based in the U.K.

Stiff Penalties

Under HMRC rules, taxpayers who fail to disclose their gain could face a 20% capital gains tax plus any interest and penalties of up to 200% of any tax due. Those found to have evaded the tax could also face criminal charges and jail terms.

HMRC published guidance on cryptocurrencies in December 2018 stating that in most circumstances it considers the disposal of cryptocurrency assets as taxable if there has been a gain.

Taxpayers who wish to disclose information that they haven't included in their self-assessed tax return can use the Digital Disclosure Service (DDS), HMRC said. The service allows taxpayers to make unprompted disclosures in exchange for reduced or no penalties.

Taxpayers shouldn't wait for the outcome of the tax office probe and should act now to ensure that they have paid what they owe, or face steep penalties, practitioners said.

"I think the revenue will have very little sympathy with people who are not compliant and they have made it clear in their December guidance," said Geraint Jones, a partner and private client tax adviser at accounting firm Berg Kaprow Lewis LLP.

"With only 20% capital gains it doesn't really make sense to run the gauntlet. Taxpayers should pay the 20% and late penalties and enjoy their gains," he added.

Difficult Calculations

"The thing that could really bite some of these traders is if they haven't recorded any paper gains they made when exchanging one cryptocurrency to another. The data being given by the exchange could show this," said

Alon Muroch, CEO of Blox.io, a software company that helps individuals calculate taxes incurred from crypto trading.

The government applies higher penalties to taxpayers it deems "careless," who include those who don't keep accurate records. Tax advisers recommend that investors collect and keep records of any crypto asset transactions if they wish to avoid the penalties.

Many traders often shave off profits to invest in new or different cryptocurrencies, said Haleemdeen.

"Often these traders take any substantial profits and reinvest them in new crypto assets hoping to replicate or grow the way they did with their initial investment and don't realize the exchange is taxable," he said.

The U.K. is just the latest of a number of countries that have gone after exchanges in their quest to tax cryptocurrency traders. The U.S. recently sent 10,000 cryptocurrency traders letters warning them to disclose any undeclared taxes.

"HMRC's advance notice 'to exchanges comes as no surprise," said Iqbal V. Gandham, U.K. managing director at eToro. He noted that crypto traders in Brazil must also report transactions to the country's National Treasury.

Exchanges Respond

Crypto exchanges are carefully analyzing HMRC's request.

"Our legal, compliance and technical teams will analyze the inquiry according to the obligations that CEX.IO has within existing regulations. Such analysis and evaluation may take some time, as regulatory obligations are very sensitive in regards to the customers' personal data," Ivanov said.

"People who cashed out at the peak, which was around about December 2017 should have disclosed those gains and paid their taxes to the revenue," Jones said.

In some cases the exchanges may not even have the taxpayer information needed for a tax disclosure, Sharon Yip, founder of Crypto Tax Advisors LLC.

"Relying on exchanges is also a dangerous game. Some only track a few months of transactions, while some shut down completely, leaving investors with no historical records of their transactions. This makes calculating profit and loss almost impossible, and could even lead to legal repercussions," she said.

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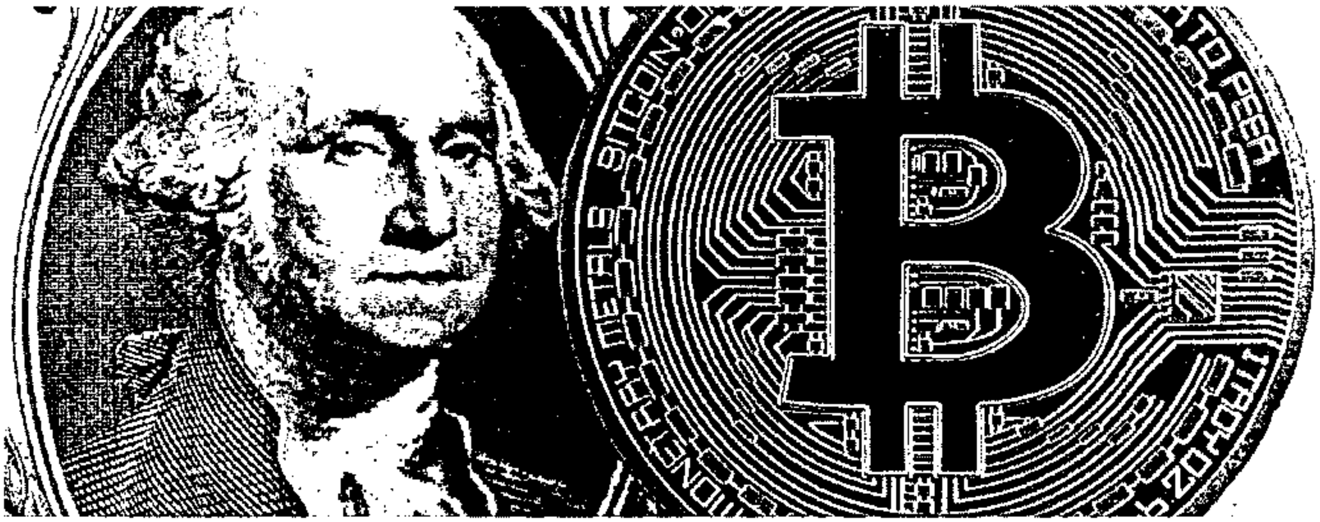

Lack of regulatory guidance contributes to the challenges of crypto tax compliance.
Photographer: Chris Ratcliffe/Bloomberg

INSIGHT: Common Issues Encountered in Crypto Tax Compliance

By David Kemmerer, Sharon Yip, and Joshua Azran Jun. 12, 2019 9:00AM

Cryptocurrency taxation is complicated, and compliance isn't helped by the lack of regulatory guidance. David Kemmerer of CryptoTrader.Tax, Sharon Yip of Crypto Tax Advisors LLC, and Joshua Azran of Azran Financial walk through five of the common issues encountered in cryto tax compliance.

Tax practitioners encounter a variety of challenges when handling cryptocurrency tax compliance for their clients. Cryptocurrency taxation is a complicated area, and there is little official guidance from regulators.

In this article, we share the most common issues that we encounter in crypto tax space. The goal is to help tax professionals who are new to cryptocurrency tax compliance.

In the article, we discuss the following five common issues:

1. Misunderstanding or lack of knowledge regarding cryptocurrency taxation

2. Skeptical cryptocurrency users—"anonymous" belief and mentality

3. Poor individual record keeping and missing data

4. Loss of access to transaction data

5. Issues related to the use of crypto tax software

Issue #1—Misunderstanding or Lack of Knowledge of Cryptocurrency Taxation

There is a lack of clarity in a number of areas of crypto taxation. Issues like the tax treatment of forks and their respective characterization, basis, recognition of income, etc. are certainly up for debate. Excellent diametrically opposing arguments can be made. These types of issues will exist unless and until there is definitive guidance.

However, underlying much of this is a fundamental misunderstanding of many individuals about the basics of taxation itself. For many people, it is not, or at least for some time, was not clear whether crypto would actually be taxable. Would there be de minimus exemptions like traditional "currency," (the operative word when examining cryptocurrency…), or is everything to be taxable, as most of us believe now?

A large amount of questionable advice and information has also been shared by purported experts and amateurs alike. This has led many people to do things like taking tax code Section 1031 treatment for their crypto trading pre-2018. In virtually all, if not all cases, this does not apply and has never applied. Worse, many of these people failed to document and disclose, based upon the misconception that Section 1031 means no taxability, and therefore also no reporting requirements. In other cases, unconscionably aggressive positions often without disclosure have been taken on returns.

One could say that the first factor of lack of clarity in guidance can be solved, and based upon recent Internal Revenue Service pronouncements, will be addressed at some point in the near to mid-term future. Fundamental misunderstandings about taxability too can be addressed, though this is and should be a cohesive effort of both the professionals in the industry and the major players like exchanges. Two of the authors herein offer professional support through training classes and coaching to tax professionals looking to gain knowledge about crypto taxation and crypto tax practice overall.

In the interim, we must look to the closest parallels in other areas of taxation and existing guidance to make decisions on things like forks, airdrops, staking, and other new areas of finance which simply have no direct identical. Is a fork more like a split, a spin-off, or a dividend? Or do none of those apply? These are questions which need to be answered in the long-term.

Issue #2—People Don't Want to Disclose All of Their Cryptocurrency Transactions

Adding to these previous issues with "misunderstandings" and "misinformation", there is yet a third layer—what we refer to as the lingering "Silk Road Effect"—whereby many people falsely believe that crypto is so anonymous that compliance is not enforceable, and by proxy therefore not necessary.

This final factor is by far the most difficult. The remaining tendency for many players in crypto to believe that this is enough of a Wild-West not to have to report, or worse, a refusal to report completely and accurately leaves professionals in a position whereby disengagement for ethical reasons is a real concern.

What we often have to explain is that the records are not, for the most part, completely anonymous. Rather, one can trace many if not most crypto transactions, and therefore, the idea of anonymity is invalid. Conceptually, crypto is a common ledger, which everyone has limited access to. It is less that nobody has the data than that everyone has the data. The only question is access, but traceability does exist. Enforcement is not only possible but probable, and more than likely, long term, much easier than other areas.

Issue #3—Poor Individual Recording Keeping or Missing Data

In order to correctly calculate gain/loss and income/expenses etc. regarding cryptocurrency related activities, all transaction data from the very beginning of the client's cryptocurrency usage needs to be accounted for. Unfortunately, many do not keep complete records for their cryptocurrency transactions. If the client had crypto transactions separate from exchanges, such as trading cryptocurrency directly with other individuals, gifting, receiving income in cryptocurrency, spending cryptocurrency in purchases, transferring cryptocurrency to a wallet or investing in an initial coin offering (ICO) or token sale etc., it is critical that the client keeps a detailed record for all of these transactions. Otherwise, they will not be able to correctly calculate the tax consequences for their tax return reporting.

If we encounter this kind of problem when handling a client's crypto tax calculation, all that can be done is to ask the client to try and figure out what happened with each missing transaction. If the client indeed cannot remember, the tax professional will need to help them come up with some kind of reasonable estimation. A conservative approach is usually recommended, i.e., treating the transaction in question as a taxable event.

It is each taxpayer's responsibility to keep a complete record of all their crypto activities. As a tax service provider, we stress the importance of record keeping to our clients and help them understand that taxpayers always bear the burden of proof if their tax return gets an IRS audit.

Issue #4—Loss of Access to Transaction Data

It is not uncommon for a client to have lost access to their crypto transaction data and even coins due to reasons like exchange shutdowns, scams, unrecoverable loss of password/private key to their online account or wallet, or the permanent loss of their hardware wallet.

Exchange shutdowns have been a problem since the early period of cryptocurrency trading. Shutdowns of exchanges like Mt. Gox, BitGrail, and recently Cryptopia have caused clients to lose access to their cryptocurrency. Those who lose coins from a shutdown are entitled to claim a loss deduction. However, no accurate calculation of the loss can be performed if no transaction data is available.

The same problem occurs for loss of transaction data and coins due to reasons other than exchange shutdowns, such as crypto investment scams, loss of private keys to an online wallet, loss of a hardware wallets etc. There is very little you can do if your client has lost access to their exchange or wallet account(s) and they don't have a record of the historical transactions. We usually suggest that our clients attempt to put all the pieces together as accurately as possible, then at the end, post a manual adjusting entry to zero out the ending balances for each "lost" account. In order to do this, all the ending balances for each existing account that the client still has access to must be reconciled first.

Issue #5—Issues Related to the Use of Crypto Tax software

Cryptocurrency tax software can be used to automatically associate historical cost basis and fair market value to crypto transactions. Tax preparers generally use these tools to import their clients historical trade data from cryptocurrency exchanges like Coinbase to then generate the reports that contain the necessary information for forms like the 8949.

Not all tax software is built equally, and common issues are seen across the board. One of the biggest challenges lies with the vast amount of exchanges and other platforms that are available for crypto users to trade or exchange tokens on. There are dozens of such platforms today. If the tax software you are using does not directly support one of these platforms, getting the historical data into the program can be incredibly tedious and require a significant amount of spreadsheet gymnastics. Manipulating data and trying to get it into the right format can chew up hours of a tax preparers time which cuts into the profitability of that client. Many platforms also limit the amount of data that can actually be imported. If a client has thousands or tens of thousands of trades, the software can get expensive.

Other issues deal with the actual functionality of these software platforms. Certain platforms offer select costing methods like FIFO or LIFO. If you or your client want to take a different approach outside one of the offered methods, the software will be less useful. Other functionality like margin trading is not commonly seen as an option on the majority of platforms today. If your client has traded crypto on margin from an exchange like Kraken or Poloniex, you need to be aware that these types of trades will be more difficult to deal with if they can't be calculated within your *crypto tax software*.

As the industry continues to grow, the software tools will continue to get better and better. Before taking on clients, you should be aware of the functionalities and limitations of your software.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

David Kemmerer is the Co-Founder and CEO of CryptoTrader.Tax, a tax reporting platform built for cryptocurrency traders and tax professionals. David and his company are focused on solving the challenges that come with tax compliance in the cryptocurrency world. With its corporate partnership with tax giant Intuit TurboTax, CryptoTrader.Tax is helping bring cryptocurrency tax reporting to the mainstream.

Sharon Yip is a CPA with 20 years of tax experience. She is the founder of Crypto Tax Advisors, LLC, a tax practice specialized in cryptocurrency taxation compliance and consulting. Sharon has extensive personal experience in cryptocurrency investment. In addition to serving crypto tax clients, Sharon is also an expert coach to other tax practitioners. She is the author of A Quick Start Guide to Cryptocurrency Taxation eBook and the creator of Mastering Cryptocurrency Taxation online course.

Joshua Azran CPA/ABV/CFF, CMA, CGMA, CFE is a multi-credentialed expert with nearly two decades of experience in accounting, tax, and finance. He is the founder of Azran Financial, one of the nation's leading firms focused on cryptocurrency tax and blockchain accounting. Joshua's clients include some of the top names in blockchain technology ranging from the exchanges to blockchain technology startups. Joshua also teaches one of the most comprehensive courses on crypto taxation for professionals, Crypto Tax Verified.

Bloomberg Law

Daily Tax Report ®

The New York City Economic Development Corp. Blockchain Center stands illuminated at night. Blockchain businesses may need to consider tax planning while still in their initial stages.

Photographer: Victor J. Blue/Bloomberg

INSIGHT: Blockchain and Distributed Ledgers—Another Wave of Challenges to Tax and Transfer Pricing From the Digital Economy

By Simon Webber, Wade Owen, and Rod Koborsi

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The blockchain industry may be in its early stages, but this is the time for blockchain businesses to consider some of the tax and transfer pricing issues raised by the technology. Simon Webber, Wade Owen, and Rod Koborsi of Duff & Phelps examine some of the unique features of such businesses and associated tax consequences.

Dramatic rises and falls in the trading value of crypto-assets have taken center stage in the blockchain space. While crypto-asset values ride this roller coaster, we should not lose sight of the development of the business changes and the related tax issues that arise from blockchain technology. Many blockchain business models are three to four years old now, and evidence of their application, and potential is becoming more visible. Distributed ledger technologies have already proved their worth in some areas where problems of identification and corruption have a high cost on limited resources as non-profit organizations (NGOs) will attest. In more entrenched and lucrative markets that the industry aims to disintermediate, such as Fintech, blockchains seem to be on the cusp of broader acceptance in initial use cases. This could signal the beginning of a substantial expansion of blockchain applications.

As these businesses gain traction and their infrastructures begin to grow and evolve, consideration of and some of the tax and transfer pricing issues raised by this technology, and related business models becomes important. In this article we provide a flavor of what distributed ledger technologies offer, how they operate, what they might become, and pose some of the "to be answered" questions that they raise for the current tax system.

WHAT IS BLOCKCHAIN?

There are numerous guides to understanding the blockchain, at a variety of reader levels, that are worth reading. The technology is constantly evolving, but hopefully the description that follows will give readers sufficient information to make our points resonate clearly. While there are slightly differing definitions of what a blockchain is, one definition that resonated with us was:

"*The blockchain is a digital ledger that is shared across a decentralized network of independent computers, which update and maintain it in a way that allows anyone to prove the record is complete and uncorrupted.*" (Michael J. Casey and Paul Vigna, *The Truth Machine: The Blockchain and the Future of Everything*, (St. Martin's Press, 2018))

At its core, blockchain technologies have their roots in trying to solve some fundamental frictions inherent within trust, reliability, and security in internet enabled-businesses. Throughout this article we use the term blockchain synonymously with peer-to-peer distributed ledger applications. The central idea is that if a wide group of independent parties agree on an event, corroborate the same record of that event and the same record leading up to the event, and those records can be protected and made difficult to invalidate or change, the more likely the event and the related transaction record is to be correct and trustworthy. If the history of transactions in the ledger also has a similar level of trustworthiness, and new transactions are permanently linked to historical transactions, the current state of the database information can be considered equally trustworthy. This level of security and immutability provides the basis for a blockchain potential application to a wide variety of uses where immutability and trust are critical to value such as stores of value, ownership of valuable assets, digital currencies, tokens, securities; or records of importance such as personnel records, voter rolls, property records, etc.

These ideas are embodied in a type of sequential transactional database called a distributed ledger, the name reflecting that multiple independent parties hold copies of the same ledger and agree to the accuracy of its historical record before accepting new transactions. Distributed ledgers are generated and operated by transaction and storage software incorporating algorithmic and cryptographic elements that establish the rules and mechanisms for agreeing with transactions and processing them onto the distributed ledger. These rules and mechanisms may address a number of processes, including queueing for processing; the validation and encryption of transactions and their links to the historical providence of the "block" to the known ledger through the determination of unique cryptographic keys; the confirmation of "proof of work", or other for consensus mechanism for validation. for a proposed block at the required level of encryption by a quorum of the other distributed ledger holders; and the cryptographic addition of these transactions to the "chain" of permanent transaction records, which then become the immutable record for all ledgers on the network. These activities are performed on a competitive basis by participants in a blockchain community, so there are also rules for re-buffering transactions that were part of potential blocks that were not ultimately agreed to by a quorum of the participants in the ledger.

It's a gross over-simplification, but the security of blockchains have several layers that may include:

• the basic requirements for the transaction information,

• trusted portals for presenting transactions to the network,

• the number of participants (nodes) in the network,

• the difficulty of the algorithmic puzzle required to "mine" a block of transactions that are encrypted correctly,

• required consistency with the previously validated historical record as part of the transaction information and encryption process,

• the quorum/number of other ledger participants that is needed to confirm the blocks' encryption solution before its acceptance onto the permanent record across all ledgers in the network, and

• how many encrypted fragments and layers that store the ledger and transaction record on the database.

The independent competitive processing and validation required in a blockchain takes time and a lot of dedicated infrastructure and energy to operate and be successful. This includes the participation of numerous independent "miners" who perform the necessary encryption and validation activity to process transaction blocks. To reward and encourage the efforts of the numbers of independent participants required to run a secure distributed ledger network, blockchains reward participants such as miners and validators for successful encryption and network acceptance of blocks, as well as other participant for activities important to the ledger's operation. Rewards for these efforts are typically granted in some form of crypto-asset. This is because many blockchain companies have spurned the more restrictive and expensive traditional angel and venture capital funding available for emerging industries and have instead self-funded by using their technology to create unique crypto-assets.

Crypto-assets can also be created directly by the distributed ledger participants. To have value, these crypto-assets need to be capable of ownership and protection, have perceived usefulness, and have liquidity, preferably into Fiat currencies. The immediate value of these crypto-assets (which can be both highly volatile and speculative) comes from others' willingness to trade them. Their long-term business value, however, should eventually reflect their use as the stores of value or "currency" that the network ecosystem uses to conduct transactions on and around the ledger.

Public blockchains may provide all these attributes directly between participants through the Internet, but many crypto-assets (including Bitcoin) are also traded on one of the numerous public trading exchanges that have sprung up for crypto-assets that provide a more familiar type of consolidated environment for the average person to trade and store these assets than more direct means of exchange. The liquidity that comes with being on a public exchange typically increases value, but also adds speculative volatility related risks. For investors and traders this might be why they are purchasing and selling these assets. For blockchain companies trying to use these assets to fund business development, however, volatility in your biggest store of value used to fund the business can distract from good business investment decisions.

Blockchain technologies are still in their relative infancy and still suffer their own frictions. While public ledger networks and private or mixed blockchains with the most stringent encryption criteria are the most secure, it may take days to settle transactions, which limits their applications to those where security takes priority over speed. For other applications where speed is more important, the validation and acceptance process may just take too long or some of the security features may need to be relaxed. In some networks, like Bitcoin, market pricing has formed around the mining fees which can be bid, and fast transaction processing is possible but at a high mining fee.

Some frictions in blockchains are creating sub-industries and new intermediaries in the disintermediation game. While mining began as a largely egalitarian endeavor across the Internet, the investment required to be successful in this activity on public ledgers has led to rapid consolidation of most of the processing power into a few industry players, mainly in China. This dependency concentration weakens the security of the ledger, and along with skepticism or regulatory need in some applications has also given rise to a growing number of private distributed ledger networks. As mentioned previously because of the inherent trust issues with the Internet, many participants in crypto-asset markets prefer to rely on exchanges or other intermediaries that may not actually be part of blockchains, but which become trusted portals. There are solutions to all of these problems that exist or are being developed, but many currently come at the expense of security in favor of processing speed and reduced cost.

With the above in mind, it can be seen that blockchains are much more than just a technology. They are new forms of more secure transactional platforms; part database, part transaction processor, part network orchestrator, and part security monitor, that offer a new approach for businesses and other applications and are therefore also evangelists' and developers' playgrounds. Blockchains have the potential to fundamentally alter the architecture that connects parties, records transactions, and maintains stores of value used across many types of applications. Like many internet-based business models, the success of a given blockchain network (and its crypto-asset value) will depend upon achieving network effects. Networks that provide appreciably better solutions than the existing database and transaction technologies will drive or generate the more transaction processing volumes, which then increases the value of the network and associated crypto-assets. Breadth of use cases, numbers of participants, ease of access, transaction processing speed, and the maintenance of security and trust are all important to long term success. Ideally, blockchain technology will facilitate a reduction in the need for intermediaries that primarily undertake activities to establish the trust necessary to make marketplaces and transactions function and will therefore reduce transaction costs. However, the potential loss of those intermediaries is also one of the problems facing the regulation and taxation of activity on blockchains.

INDUSTRY DEVELOPMENT AND VALUE DRIVERS

As a transactional database technology, many blockchain businesses are essentially technology enabled transaction networks. While one of their goals is to disintermediate certain transactions and markets, in some instances blockchain companies may not actually be blockchain participants but aspire to become new, hopefully leaner, intermediaries. As highlighted above, blockchain companies hoping to succeed in the market need not only better technology solutions than offered by competitors, but also the wide adoption by participants to conduct large numbers of transactions using their technology to achieve the desired network effects. Developing all these attributes is an iterative process of platform and feature development, and incentives to one side or the other of the platform until a critical mass of actors is attained and a virtuous cycle of network effects takes hold to drive transaction volumes.

Public or industry blockchain distributed ledgers are neither owned nor controlled by any one party. Instead they are usually overseen by a foundation comprising the participants and other stakeholders. Ideally the more open, distributed and diverse the participation in a ledger is, the more secure it is likely to be. Private blockchains are also being created among industry participants in which there are a reduced number of "trusted" network participants or network nodes. Depending on the encryption and validation rules of these blockchains, this may make these ledgers quicker to process transaction, but at a trade-off of lower security.

Currently, blockchain technology is such that intermediaries have naturally formed around many blockchains to facilitate trust in these new businesses, enhancing access and liquidity in the process. As previously mentioned, there are also concentrations of resources that are devoted to the infrastructure supporting public ledgers in the mining space, particularly in China. No doubt, other sub-industries will emerge as the use of these technologies grows and market forces act to address blockchains own frictions.

As nascent businesses, new blockchain companies start life by identifying the niche or need they are trying to solve. Some are focused on particular markets, transactional areas or businesses. Others are broader and more foundational. Whatever their application, new blockchain companies must first identify the use case and refine the technology to this application and prove their incremental benefits over incumbent solutions by demonstrating reduced cost, increased security, increased speed, or all of the above. In this respect several platforms like Ethereum have emerged that both provide the building blocks for and host distributed ledgers. These may also have their own crypto-asset or allow creation of compatible ones.

With regards to technology, public blockchain technology is based on open source code and therefore patents and other legal protections to the technology are generally limited to methods, processes, and know-how. This is not a huge issue for sustainable advantage—there are many industries, including the existing database industry, that use open source code. However, it may complicate the understanding value drivers, value of specific use cases of the technology, and the attribution of ownership in these businesses.

Blockchains that make it to proof-of-concept for their technology solution with a viable use case will need to attract Alpha participants and find test transactions to work on to gain trust and show realization of their potential. This can be a costly and time-consuming exercise. With a shortage of blockchain-skilled engineers, there is a current bottleneck in getting adoption of blockchain solutions within many operating businesses. Further, for many businesses and target markets for blockchains, the highest initial returns go to adopters in less well-developed markets and use cases, where transaction friction and intermediary costs are greatest. For some, their business models and target markets may necessarily need to adapt to on-the-ground market conditions and receptiveness. Most blockchain companies, like Internet companies before them, are trying out different business and revenue models to find the best ones and/or gain faster adoption.

Much of the early stage technical and network development that is undertaken is generally conducted centrally in the core of the business, working directly with chief technologists and the initial customers around the world. However, as noted above, many initial customers and test use cases are outside of traditional, mature markets, and the value of building out networks internationally as quickly as possible is understood, so we see these businesses establishing local presences quite quickly, even though their activities may appear quite limited. These local offices may perform a mixture of technology evangelism, market research, customer identification, and pre-sales validation and preparation.

As customers start to take interest in the technology, local activities will necessarily start to include technical support for evaluation, testing, and hopefully implementation and support. Engineers and consultants may work at client sites designing and advising on use cases, evaluation and implementation. If blockchain follows the sort of development profile we have seen for other new software adoption, it's likely these initial steps and customers will lead to more standardized products and implementation that can scale the adoption of the technology more quickly and efficiently. This will be key to building their networks and will also lead to more ability for local parties to make sales and manage local customer accounts. As such understanding the roles and successful contributions for each business may take investigation and an understanding of the history of business or industry and the main twists and turns.

Eventually, successful blockchain networks may come to dominate their markets or the nature of the industry may naturally lead to concentration to maximize volumes and cost efficiency. If too powerful, this may stifle competition and given rise to the type of monopolistic or oligopolistic tendencies we see in many digital market places. However, as we can see, blockchain technologies and companies have a very long way to go before they have to worry about those problems. In most respects, blockchain technologies are really just reaching first base.

UNIQUE FEATURES AND ASSOCIATED TAX CONSEQUENCES

Blockchain businesses are rather unique in their ability to create valuable, tradable crypto-assets to self-fund their initial development, despite not having established businesses. These assets give rise to a number of tax consequences depending on their character and usage. As the most valuable part of many of these businesses, the use and/or trading of these assets may be the single biggest source of revenue for many blockchain companies. These are a natural focus for tax authorities and regulators at the moment, but a discussion of these tax consequences is best left to those more knowledgeable in these areas. From a business perspective, however, crypto-asset values should eventually be reflective of the success of the blockchain network and their usage within the ecosystem. The unique features and tax consequences we highlight are as follows:

1) Blockchain and the Nexus Test,

2) Key Intangible Assets in Blockchain and Tax Planning Opportunities, and

3) Use of Blockchain in Tax Compliance

Blockchain and the Nexus Test

Blockchains potentially raise even more problems for taxable income sourcing for the international tax community than other digital businesses, and may give rise to complex determinations around nexus, sourcing, character, and value attribution where such determinations need to be made.

This is because:

• A block of transactions requires both successful encryption and successful validation by a quorum of other participants before it is "accepted" and the transactions therein are approved and become part of the permanent ledger record. While multiple ledger participants are necessary, any individual participant is also redundant, i.e., no one ledger participant executes a transaction, controls the ledger, or is needed for the ledger to be sustained.

• Some blockchains have layers of cryptographic and physical security, which may mean that an instance of the ledger at one participant may be itself dispersed among servers and locations within that participant. This may give at least the appearance of having multiple ledger owners and therefore potential for controversy around income attributable not only to participants but also within participants, and assertions of ownership of the database assets.

• Individual engineering efforts, efforts to proselytize on behalf of a particular company, or attract Alpha or Beta customers, all of which are part of the steps necessarily to get the business off the ground and build the network, may give rise to a wide variety of views over the attribution of value related to these network effects.

All these factors make the locus of a transaction difficult to determine under the current international tax nexus rules. In public ledgers, which use the Internet, it may be impossible to identify the specific miners and validators, but it may also be unnecessary given they are mainly independent and remunerated with an arm's-length fee. For private ledgers, all parties involved in the transaction are likely to be known. However, when a transaction takes place in a public network, it may be difficult to describe—in the context of a tax audit—where assets are held and by whom, and who controls the ledger. Sub-industries participating in public ledgers may provide a clear location and potential arm's-length pricing for certain individual participant activities, but the focus for tax nexus of the transactions running through distributed ledgers likely need to be on the participants on either side of the transactions being processed, or where the transaction is introduced to the ledger absent other factual points of reference.

From an economic and risk perspective, currently the local operations of many of these businesses are set up as cost plus service provides and supported with one sided testing using the transactional net margin method (TNMM)/comparable profits method (CPM). If blockchain companies grow their network and start to become profitable, local markets are likely going to want a larger share of the pie reflecting their "market" contribution to the network. In this case, it may be appropriate to view and characterize their current activities differently and give some thought to related bearing of losses required to reach those future network profits.

Key Intangible Assets in Blockchain and Tax Planning Opportunities

In these early stages of the blockchain industry and businesses, many of the key assets and intangibles have yet to be created. Technologies (i.e., processes and know-how), business models, engineering workforce, and management expertise are likely the main existing intangibles. In discussing each entities' contributions to the development or use of intangibles across a multinational enterprise, the 2017 Organization for Economic Cooperation and Development (OECD) Guidelines refer to a new analysis called "DEMPE." A DEMPE analysis refers to identifying entities involved in the development, enhancement, maintenance, protection, and exploitation of intangibles. The DEMPE functions for key technologies in a public blockchain business may be a mixture of community property and community developer contributions under a foundation, and unique company or business application specific overlays, solutions and adaptations that may be developed, owned and legally protected by individual companies. Private blockchain networks may have completely owned and developed technologies. Ownable technologies may be centralized around sources of investment and related DEMPE functions. Engineering workforces in place with blockchain experience may have premium value, as will other positions where resources are scarce.

Premiums, however, may be temporary as returns attract new resources. The value some intangibles associated with blockchain businesses have may well be limited to their replacement cost until profitable businesses emerge. Individual and collective customer, supplier and/or market participant intangibles will grow in importance as the business grows. All elements of networks are important, some having more importance than others during different times in the development of the network. Over time and with success, the business may also generate network brand value based on its trust and performance.

Depending on the development of the business and network, local market contributions may be limited, but that is may change over time and the historical investments and contributions should also factor into this assessment. The accessibility of the Internet may also mean that competitive and disruptive blockchain networks, like their current digital market place cousins, may attract users from countries where the businesses themselves do not have any presence or a relatively minor one. This may also lead to similar challenges from these markets for some form of taxable income to be earned regardless of any currently agreed tax nexus from local transactions, people, assets, or activity (DEMPE or otherwise).

The embryonic stage of blockchain companies can provide these companies with intellectual property (IP) planning opportunities within the base erosion and profit shifting (BEPS)-inspired tax legal frameworks that emerges from the current chaos. Many important assets are still to be created as they work to increase adoption across multiple jurisdictions and markets. The optimal tax structure depends on a number of factors, including where the company operates, main customers/target markets, how it intends to go to market, and the likely tax attributes that will arise along the road ahead. For some companies, this may mean two or more subsidiaries entering into joint development or cost sharing arrangements as regional expansion occurs, buying into the pre-existing intangibles through a platform contribution transaction to take advantage of potentially more optimal (tax or regulatory) non-U.S. locations, despite the risk that aggressive tax authorities challenge the company's attribution of IP ownership and risks. For others, it could mean a businesses's U.S. entity acquiring (or retaining) IP to centralize ownership and economic exploitation rights associated with its blockchain technologies, using the U.S. as a shield against BEPs abuse claims. In both circumstances, tax executives are in a better position to implement new tax structures while the IP is relatively less valuable and largely unproven in the market.

When considering their tax structures, blockchain companies with a presence in the U.S. should consider the complicating impact of the 2017 Tax Cuts and Jobs Act (TCJA). A company's attributes and benefits under TCJA are often highly specific to its facts and circumstances. Structure, characterization, and sourcing may affect the key international provisions around global intangible low-taxed income (GILTI), foreign-derived intangible income (FDII), base erosion and anti-abuse tax (BEAT), and foreign tax credits. Capital investment and engineering may be affected by accelerated and/or delayed deductions, all of which may affect their operating cash flows and valuations. Other countries have introduced tax incentives and/or specific regulatory measures that provide blockchain companies with more certainty around the regulation and tax treatment of transactions in crypto-assets and of network profits. Consequently, the assessment of optimal operating and tax structures is very much a moving target for many blockchain companies.

Role of Intermediaries and Use of Blockchain in Tax and Transfer Pricing Compliance and Collection

A further interesting aspect of blockchains is their impact on tax administration and compliance. In many market places or supply chains, intermediaries are not only the sources of trust for participants, but also the gateways by which regulators and tax authorities may monitor and capture information about transactions and participants. An obvious example of this are companies like brokers, that may record transactions, withhold taxes, prepare statements, report gains and losses and basis to customers and to the tax authorities. Where blockchains disintermediate actors within the supply chain, tax authorities may find themselves blind to these transactions and reliance on much less sophisticated or compliance knowledgeable users and participants to self-report.

We already note that many business models in the Blockchain 1.0 world involve new intermediaries which may be conscripted to take on that role like the crypto-asset/coin-trading exchanges. Even in a world where the blockchains achieve their nirvana and intermediaries disappear, blockchains can include the development of smart contracts for transaction execution, elements of which governments may add to monitor transactions and even potentially perform necessary tax compliance and collection activities. Smart contracts may actually provide the ability to do this in real time rather than waiting for estimated payments or returns to be filed. These same smart contracts may also be used by intercompany participants in a blockchain to execute transfer pricing and profit allocations in the network.

CONCLUSIONS

It is clear that blockchain technologies and businesses provide challenges and opportunities for tax administrations as well as taxpayers and their advisors. From a tax perspective, it's clear that it's going to be difficult to fit some of the facts around blockchain-related transactions into the current international tax framework and guidance is needed. Taxable income models that attribute value to contributions and thereby determine transfer pricing and profit or loss outcomes will require additional thought. On the other hand, for businesses in this space, now is the time to think about the most efficient future operating structures while the cost of creating or moving key elements of future business value is not prohibitive.

This will no doubt become an increasing focus of the OECD and international community over the next few years as blockchain enabled technologies gain traction. The OECD has devoted efforts to understand the blockchain industry and its challenges, having had initial exploratory conference between policy makers, followed by its first public annual Blockchain Policy Forum in 2018, with another planned for September 2019.

We note that the international tax world is currently in the throes of a reevaluation of the distribution of and taxation of the spoils from the Internet's biggest businesses. These are familiar areas of debate around the taxation of the digital economy under BEPS Action 1 and the ongoing discussions at the OECD, most recently elaborated in the *Addressing the Tax Challenges of the Digitalization of the Economy – Policy Note of January 23, 2019*. One of the vexing problems within this debate is how to consider the changing importance of capital, assets, and activity contributions during the evolution of these businesses, and to recognize the parties that made those investments and contributions over time. In technology-based digital market places and networks these may track the development of the initial technology and a successful business model, the investments in different sides of market place or to gain network users and, if successful, the emergence of brands and adjacent or new uses for the platform.

All elements were needed to reach the position where these large digital companies achieved the network effects they currently enjoy (and to become a transfer pricing/profit attribution problem for governments), and all required some level of risk and investment to be made. Blockchain technologies and businesses may well reach a similar point in their future; however, as of now most blockchain businesses are at a stage in their development that there's much less operating profit, if any, to fight over. However, as policy makers and tax authorities tackle the more immediate issues surrounding crypto-assets, we suggest that they also take time to observe the changes and forces at work in this industry's development as it may help build a better approach to some of the tax issues with the digital economy.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Simon Webber is a managing director and Wade Owen and Rod Koborsi are directors in the transfer pricing practice at Duff & Phelps's Silicon Valley office.

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FinCEN Issues Guidance to Synthesize Regulatory Framework for Virtual Currency

By Jenny Konko and Burr Eckstut on May 21, 2019
Posted in Regulatory Compliance

On May 9, 2019, the Financial Crimes Enforcement Network ("FinCEN") published **interpretive guidance** to reiterate how FinCEN's existing regulations relating to money services businesses ("MSBs") apply to business models involving convertible virtual currencies ("CVCs"). The guidance is the most significant CVC-related guidance that FinCEN has released since its 2013 guidance on the application of money transmission regulations to CVC transactions. The guidance does not establish any new regulatory requirements but, rather, synthesizes FinCEN's existing framework of regulations, administrative rulings, and guidance since 2011 and applies this framework to common business models involving CVCs.

The guidance largely focuses on the activities (i.e., business models) that will cause a person to be a "money transmitter" under FinCEN's MSB regulations. For this purpose, a money transmitter is a person who accepts value from one person and transmits value to another location or person by any means. Money transmitters are required to register as MSBs and comply with anti-money laundering ("AML") requirements, including AML compliance program recordkeeping, monitoring, and reporting requirements.

The regulatory interpretations contained in the guidance may extend only to other business models consisting of the same key facts and circumstances as the business models described in the guidance. Similarly, a person who is engaged in more than one type of business model may be subject to more than one type of regulatory obligation or exemption.

Some of the business models described in the guidance include:

- **Peer-to-Peer ("P2P") Exchangers.** P2P exchangers engaged in the business of buying and selling CVCs – including facilitating transfers from one type of CVC to a different type of CVC, as well as exchanges between CVC and other types of value – are money transmitters, whether their activities are conducted online or in person. A natural person that acts as a P2P exchanger on an infrequent basis and not for profit or gain will be exempt from the definition of money transmitter.
- **CVC Wallets.** Whether a CVC wallet provider is a money transmitter depends on four factors: (a) who owns the value; (b) where the value is stored; (c) whether the owner interacts directly with the payment system where the CVC runs; and (d) whether the person acting as intermediary has total independent control over the value. Hosted wallet providers – account-based providers that receive, store, and transmit CVC on behalf of CVC owners – are money transmitters. However, the applicable regulatory framework, including the due diligence or enhanced due diligence procedures the CVC wallet provider must follow, varies based on the identity of the wallet owner and the nature of the transactions conducted through the hosted wallet. By contrast, owners of unhosted wallets – computer software that allows the owners to store and conduct CVC transactions – are not money transmitters. Multiple-signature wallet providers may be money transmitters depending on the services they offer. For example, if the multiple-signature wallet provider limits its role to creating un-hosted wallets that require the addition of a second authorization key to the wallet owner's private key in order to validate and complete transactions, the wallet provider is not a money transmitter because it does not accept and transmit value.

- **CVC Kiosks.** The owner-operator of an ATM-like electronic terminal that facilitates the exchange of CVC for currency or other CVC is a money transmitter.
- **Decentralized Applications (DApps)**. DApps – software programs that operate on a P2P computer network running a blockchain platform, but lacking an identifiable administrator – may be money transmitters depending on whether they transmit value. Developers who build DApps financed by an initial coin offering ("ICO") are not money transmitters because the activity consists of producing a good or service. However, if the DApp developer uses the DApp to engage in money transmission, it will qualify as a money transmitter.
- **Payment Processors**. CVC payment processors are financial intermediaries that enable traditional merchants to accept CVC from customers in exchange for goods and services. CVC payment processors fall within the definition of "money transmitter" and generally do not satisfy the "payment processor" exemption to the definition of "money transmitter" because such money transmitters typically do not operate, either in whole or in part, through a clearance and settlement system that admits only Bank Secrecy Act-regulated financial institutions. As such, CVC payment processors generally will need to register with FinCEN as an MSB.
- **CVC Trading Platforms and Decentralized Exchanges.** CVC trading platforms that enable buyers and sellers of CVC to find each other, or facilitate trades as an intermediary, are money transmitters if the platform purchases CVC from the seller and sells it to the buyer. A platform that is merely a forum for buyers and sellers to post bids (but the parties themselves settle the matched transaction through an outside venue) is not a money transmitter.

FinCEN issued the interpretive guidance in conjunction with a separate **advisory** to help financial institutions identify and report suspicious activity involving virtual currency transactions. The advisory document warns that bad actors are increasingly using CVCs for money laundering, sanctions evasion, and other illicit financing purposes. The advisory highlights prominent typologies associated with such illicit activity, and provides a list of 30 "red flags" that MSBs and other financial institutions should watch for in evaluating potential suspicious activity. Finally, the advisory reminds financial institutions of their legal obligation to file suspicious activity reports ("SARs"), and identifies the types of information that are most helpful to law enforcement to be included in SARs.

The release of the FinCEN guidance and advisory were followed by a May 13 **speech** by Sigal Mandelker, the Treasury Department's Under Secretary for Terrorism and Financial Intelligence, who is responsible for overseeing FinCEN regarding the AML and sanctions risks associated with virtual currency. Mandelker described how bad actors, including nations like Iran, North Korea, and Russia, are turning to virtual currencies as a method to evade economic sanctions. Similarly, terrorist organizations are using bitcoin to solicit donations from terrorist sympathizers. Mandelker praised FinCEN for its role in protecting national security and the virtual currency industry through its regulations and enforcement actions, including the release of the guidance and advisory.

Notice 2014-21

SECTION 1. PURPOSE

This notice describes how existing general tax principles apply to transactions using virtual currency. The notice provides this guidance in the form of answers to frequently asked questions.

SECTION 2. BACKGROUND

The Internal Revenue Service (IRS) is aware that "virtual currency" may be used to pay for goods or services, or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. For a more comprehensive description of convertible virtual currencies to date. see Financial Crimes Enforcement Network (FinCEN) *Guidance on the Application of FinCEN's Regulations to Persons Administering. Exchanging. or Using Virtual Currencies* (FIN-2013-G001, March 18, 2013).

SECTION 3. SCOPE

In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. This notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term "virtual currency" as used in Section 4 refers only to convertible virtual currency. No inference should be drawn with respect to virtual currencies not described in this notice.

The Treasury Department and the IRS recognize that there may be other questions regarding the tax consequences of virtual currency not addressed in this notice that warrant consideration. Therefore, the Treasury Department and the IRS request comments from the public regarding other types or aspects of virtual currency transactions that should be addressed in future guidance.

Comments should be addressed to:

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2014-21)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered Monday through Friday between the hours of 8 A.M. and 4 P.M. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2014-21)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, taxpayers may submit comments electronically via e-mail to the following address: Notice.Comments@irscounsel.treas.gov. Taxpayers should include "Notice 2014-21" in the subject line. All comments submitted by the public will be available for public inspection and copying in their entirety.

For purposes of the FAQs in this notice, the taxpayer's functional currency is assumed to be the U.S. dollar, the taxpayer is assumed to use the cash receipts and disbursements method of accounting and the taxpayer is assumed not to be under common control with any other party to a transaction.

SECTION 4. FREQUENTLY ASKED QUESTIONS

Q-1: How is virtual currency treated for federal tax purposes?

A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?

A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.

Q-3: Must a taxpayer who receives virtual currency as payment for goods or services include in computing gross income the fair market value of the virtual currency?

A-3: Yes. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency,

measured in U.S. dollars, as of the date that the virtual currency was received. See Publication 525, *Taxable and Nontaxable Income,* for more information on miscellaneous income from exchanges involving property or services.

Q-4: What is the basis of virtual currency received as payment for goods or services in Q&A-3?

A-4: The basis of virtual currency that a taxpayer receives as payment for goods or services in Q&A-3 is the fair market value of the virtual currency in U.S. dollars as of the date of receipt. See Publication 551, *Basis of Assets,* for more information on the computation of basis when property is received for goods or services.

Q-5: How is the fair market value of virtual currency determined?

A-5: For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.

Q-6: Does a taxpayer have gain or loss upon an exchange of virtual currency for other property?

A-6: Yes. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. See Publication 544, *Sales and Other Dispositions of Assets*, for information about the tax treatment of sales and exchanges, such as whether a loss is deductible.

Q-7: What type of gain or loss does a taxpayer realize on the sale or exchange of virtual currency?

A-7: The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or

business are examples of property that is not a capital asset. See Publication 544 for more information about capital assets and the character of gain or loss.

Q-8: Does a taxpayer who "mines" virtual currency (for example, uses computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger) realize gross income upon receipt of the virtual currency resulting from those activities?

A-8: Yes, when a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. See Publication 525, *Taxable and Nontaxable Income*, for more information on taxable income.

Q-9: Is an individual who "mines" virtual currency as a trade or business subject to self-employment tax on the income derived from those activities?

A-9: If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax. 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 on to make a profit.

Q-10: Does virtual currency received by an independent contractor for performing services constitute self-employment income?

A-10: Yes. Generally, self-employment income includes all gross income derived by an individual from any trade or business carried on by the individual as other than an employee. Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax. See FS-2007-18, April 2007, *Business or Hobby? Answer Has Implications for Deductions*, for information on determining whether an activity is a business or a hobby.

Q-11: Does virtual currency paid by an employer as remuneration for services constitute wages for employment tax purposes?

A-11: Yes. Generally, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions

Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, *Wage and Tax Statement*. See Publication 15 (Circular E), *Employer's Tax Guide*, for information on the withholding, depositing, reporting, and paying of employment taxes.

Q-12: Is a payment made using virtual currency subject to information reporting?

A-12: A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities, and compensation.

Q-13: Is a person who in the course of a trade or business makes a payment using virtual currency worth $600 or more to an independent contractor for performing services required to file an information return with the IRS?

A-13: Generally, a person who in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, *Miscellaneous Income*. Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in U.S. dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC. See the Instructions to Form 1099-MISC and the General Instructions for Certain Information Returns for more information. For payments to non-U.S. persons, see Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

Q-14: Are payments made using virtual currency subject to backup withholding?

A-14: Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payor must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required. See Publication 1281, *Backup Withholding for Missing and Incorrect Name/TINs*, for more information.

Q-15: Are there IRS information reporting requirements for a person who settles payments made in virtual currency on behalf of merchants that accept virtual currency from their customers?

A-15: Yes, if certain requirements are met. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, *Payment Card and Third Party Network Transactions*, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds $20,000. When completing Boxes 1, 3, and 5a-1 on the Form 1099-K, transactions where the TPSO settles payments made with virtual currency are aggregated with transactions where the TPSO settles payments made with real currency to determine the total amounts to be reported in those boxes. When determining whether the transactions are reportable, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.

See The Third Party Information Reporting Center, http://www.irs.gov/Tax-Professionals/Third-Party-Reporting-Information-Center, for more information on reporting transactions on Form 1099-K.

Q-16: Will taxpayers be subject to penalties for having treated a virtual currency transaction in a manner that is inconsistent with this notice prior to March 25, 2014?

A-16: Taxpayers may be subject to penalties for failure to comply with tax laws. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under section 6721 and 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Keith A. Aqui of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information about income tax issues addressed in this notice, please contact Mr. Aqui at (202) 317-4718; for further information about employment tax issues addressed in this notice, please contact Mr. Neil D. Shepherd at (202) 317- 4774; for further information about information reporting issues addressed in this notice, please contact Ms. Adrienne E. Griffin at (202) 317-6845; and for further information regarding foreign currency issues addressed in this notice, please contact Mr. Raymond J. Stahl at (202) 317- 6938. These are not toll-free calls.

New FinCEN Guidance Affirms Its Longstanding Regulatory Framework for Virtual Currencies and a New FinCEN Advisory Warns of Threats Posed by Virtual Currency Misuse

Contact: Public Affairs, 703-905-3770
Immediate Release: May 09, 2019

WASHINGTON—To provide regulatory certainty for businesses and individuals engaged in expanding fields of financial activity, the Financial Crimes Enforcement Network (FinCEN) today issued the following guidance, Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies (CVC) (https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-certain-business-models). The guidance is in response to questions raised by financial institutions, law enforcement, and regulators concerning the regulatory treatment of multiple variations of businesses dealing in CVCs.

FinCEN today also issued an Advisory on Illicit Activity Involving Convertible Virtual Currency (https://www.fincen.gov/resources/advisories/fincen-advisory-fin-2019-a003) to assist financial institutions in identifying and reporting suspicious activity related to criminal exploitation of CVCs for money laundering, sanctions evasion, and other illicit financing purposes. The advisory highlights prominent typologies, associated "red flags," and identifies information that would be most valuable to law enforcement if contained in suspicious activity reports.

"Treasury is committed to helping financial institutions better detect and prevent bad actors from exploiting convertible virtual currencies for money laundering, sanctions evasion, and other illicit activities," said Sigal Mandelker, Under Secretary of the Treasury for Terrorism and Financial Intelligence. "The comprehensive advisory FinCEN issued today highlights the risks associated with darknet marketplaces, peer-to-peer exchangers, unregistered money services businesses, and CVC kiosks and identifies typologies and red flags to help the virtual currency industry protect its businesses from exploitation."

"FinCEN was the first financial regulator to address virtual currency and the first to assign obligations to related businesses to guard against financial crime," said FinCEN Director Kenneth A. Blanco. "The money transmitter definition we published in 2011 and the guidance we issued in 2013 clarifying how that definition applies to transactions involving virtual currency have proven to be exceptionally durable. Our regulatory approach has been consistent and despite dynamic waves of new financial technologies, products, and services, our original concepts continue to hold true. Simply stated, those who accept and transfer value, by any means, must comply with our regulations and the criminal misuse of any methodology remains our fundamental concern."

Today's guidance does not establish any new regulatory expectations. It consolidates current FinCEN regulations, guidance and administrative rulings that relate to money transmission involving virtual currency, and applies the same interpretive criteria to other common business models involving CVC. FinCEN's rules define certain businesses or individuals involved with CVCs as money transmitters subject to the same registration requirements and a range of anti-money laundering, program, recordkeeping, and reporting responsibilities as other money services businesses.

The mission of the Financial Crimes Enforcement Network is to safeguard the financial system from illicit use, combat money laundering, and promote national security through the strategic use of financial authorities and the collection, analysis, and dissemination of financial intelligence.

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Paul William M

From: Cullinan Thomas A
Sent: Thursday, June 13, 2019 6:17 PM
To: Paul William M
Subject: RE: Crypto and VC

[redacted] (b)(5) Deliberative Process Privilege

From: Paul William M <[redacted] (b)(6)
Date: Thursday, Jun 13, 2019, 9:22 AM
To: Cullinan Thomas A <[redacted] (b)(6)
Subject: Crypto and VC

Tom,

[redacted] (b)(5) Deliberative Process Privilege

Bill

Paul William M

From: Cullinan Thomas A
Sent: Monday, June 10, 2019 6:16 PM
To: Paul William M
Subject: RE: FinCEN guidance

(b)(5) Deliberative Process Privilege

[redacted]

From: Cullinan Thomas A
Sent: Monday, June 10, 2019 6:02 PM
To: Paul William M [redacted] (b)(6)
Subject: FinCEN guidance

Bill – Here is a link to the guidance I mentioned. FinCEN used a blanket qualification on definitions on the bottom of page 1, and then added some specific qualifications to the definition of "virtual currency" on page 7.

https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf

32 No. 3 Prac. Tax Law. 56

Practical Tax Lawyer
Spring 2018

Sarah-Jane Morin[a1]

TAX ASPECTS OF CRYPTOCURRENCY

WESTLAW LAWPRAC INDEX

GPR – General Practice Approaches, Articles & Issues

"I am hoping it goes away."

"What do you use it for again?"

"Is that something I really need to know?"

These are just a few of the responses I received after asking my tax colleagues for their thoughts on **cryptocurrencies**. These interactions take me back in time to the beginning of smartphones. We as the legal industry slowly accepted that we could not type formal memoranda on our smartphones and would need to either accept short form responses or run to our computers at all hours. We struggled against it; we complained. We told younger attorneys that they were too informal in their emails. Over time, we became fine with sending a "pls do" or "thx" email or even--the horror--a smiley face response. And here we are, attached to our smartphones.

Now, I can't say that we as the legal industry will start accepting payment for services in Bitcoin--but who knows? Some firms accept payment in part in stock of their client, and I am guessing there is a law firm or two out there that will take Bitcoin as payment. At the very least, some of our clients are accepting Bitcoin as payment for services and goods in many cases. We in the legal industry will have to start paying more attention to **cryptocurrency**. We may at times be behind the curve and need to catch up to our clients.

I was reminded of this issue recently, which inspired this article. A few months ago, I went to purchase a patio set for my house. After much turmoil and back-and-forth, I found the best price for the set that I wanted on a very well-known discount retailer's website. Finally, the decision was made, the furniture was in my online shopping cart, and I went to pull out my credit card. I then noticed that one of my payment options was Bitcoin. So, it's here, folks. Major retailers are accepting **cryptocurrency**. This is unlikely to change any time soon. Let's consider what this means for those of us do some tax law.

WHAT IS CRYPTOCURRENCY?

As a starting point, we should consider what is actual, non-virtual currency or "real money," if you will. Most commonly, real money or actual currency is currency issued through and backed by a country's government. The obvious example is the U.S. dollar. What is **cryptocurrency** in that case? **Cryptocurrency** (sometimes called "alternative currency" or "virtual currency") is a digital medium of exchange, and it is not issued or backed by a government.[1] **Cryptocurrency** may bring to mind dramatic movie scenes of nerdy yet trendy young professionals crowded around a computer screen watching virtual currency exchanges. It may even conjure up images of illicit exchanges and secret, illegal markets. No doubt the latter is in part attributable to the infamous Silk Road website [2] and perhaps also attributable to the stories surrounding the mysterious inventor of Bitcoin, Satoshi Nakamoto. Satoshi Nakamoto was (is?) a person or group of people who started Bitcoin in 2009. [3] Newsweek in 2014 identified this mysterious figure as a 64-year-old man living in California. [4] That turned out to be incorrect. More recently, there was a belief in the cryptocurrency community that the real creator was Craig Wright, an entrepreneur from Australia. [5] The mystery remains and his identity is still a mystery.

Whoever is the real wizard behind the curtain, most people think of Bitcoin when they think of cryptocurrency. Certainly Bitcoin is the most blogged-about and *57 written-about cryptocurrency, and perhaps therefore the most well-known cryptocurrency, especially to those of us who do not have a lot of experience in this area. Bitcoin was also the first cryptocurrency created. [6] But it turns out there are far more cryptocurrencies out there for consumption, and the technology supporting cryptocurrency (referred to as "blockchain") may have far greater uses than only cryptocurrency. [7] Given this expanding space, we should understand the basics of the tax aspects of cryptocurrency.

WHAT IS CRYPTOCURRENCY FOR U.S. FEDERAL INCOME TAX PURPOSES?

Cryptocurrency is not regulated by a centralized bank or any centralized governmental system. With all my talk of buying patio furniture with Bitcoin, that may come as a surprise. Wouldn't the government want to make sure that what seems to be a medium of exchange akin to a currency is regulated? And shouldn't the U.S. Internal Revenue Service ("IRS") weigh in on how it is treated for tax purposes?

The various arms of the U.S. government have been arguably slow to act in this area, but some guidance has been provided. Notably, in 2013, the Financial Crimes Enforcement Network ("FinCEN") issued guidance regarding the treatment of persons who use convertible virtual currencies or make a business of exchanging, accepting, and transmitting them. [8] FinCEN took the position in such guidance that, depending on the type and extent of activities involved, such persons may be treated as "money service businesses" ("MSBs") and accordingly are required to comply with FinCEN's regulations that require maintaining an anti-money laundering program as well as meeting registration and various reporting requirements. [9] FinCEN distinguishes between "users" of cryptocurrency (i.e., those who may use cryptocurrency to make a purchase of goods or services) and "exchangers," who engage in the business of cryptocurrency. [10] Users are not subject to the MSB rules whereas exchangers are. This is not a dissimilar structure from the use of "real money" or "actual currency," in that those people spending money to buy goods and services are not subject to FinCEN's regulations, whereas a bank or other agency facilitating the exchange of real money, holding deposits of real money, and performing other similar actions, would be subject to FinCEN's regulations. [11] The Commodity Futures Trading Commission ("CFTC") has also weighed in with its view, stating in 2015 that Bitcoin and other virtual currencies are "commodities." [12] Section 1a(9) of the Commodity Exchange Act, as amended, defines "commodity" to include, among other things, "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." [13]

After years of waiting for the IRS to act, taxpayers received some cryptocurrency tax guidance. The IRS released Notice 2014-21 on March 25, 2014 (the "Notice"). [14] The purpose of the Notice is to describe how existing general tax principles apply to transactions using virtual currency. [15] The guidance in the Notice is provided in the form of answers to certain frequently asked questions ("FAQs"). The IRS is clear in the Notice that the guidance applies to "convertible" virtual currency, or that which has "an equivalent value in real currency, or that acts as a substitute for real currency." [16] Essentially, this captures cryptocurrencies that are a substitute for money. The Notice does not specifically list which **cryptocurrencies** should be included in this list of convertible virtual currencies (but does reference Bitcoin as one example). The Notice refers to FinCEN's guidance for a comprehensive description of convertible virtual currencies as of the date of the Notice. [17] While helpful that any guidance has been provided, we are left to wonder not only what **cryptocurrencies** should be considered "convertible" and therefore fall within the purview of the Notice, but also how the guidance in the Notice might apply to nonconvertible **cryptocurrencies**, if at all.

(b)(5) Deliberative Process Privilege

The IRS addresses the federal tax treatment of convertible **cryptocurrency** in its first FAQ and states that, "[for] federal tax purposes, virtual currency is treated as property." [18] What does treatment as "property" mean for U.S. federal income tax purposes? This means that general tax principles that apply to property transactions apply to transactions using virtual currency, just as they would for any other property. [19] Further, this means in part that **cryptocurrency** cannot generate foreign currency gain or loss for U.S. federal income tax purposes because it is not a foreign currency (rather, it is a property). [20]

As property, convertible **cryptocurrency** must have a tax basis. As one example, the IRS states in the Notice that the basis of virtual currency that a taxpayer receives as payment for goods or services is the fair ***58** market value of the virtual currency in U.S. dollars as of the date of receipt. [21] Determination of fair market value depends on whether the **cryptocurrency** is listed. If listed on an exchange and the exchange rate in U.S. dollars is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency that in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied. [22] If not listed on an exchange, the Notice provides no further guidance on the fair market value determination.

Taxpayers must track **cryptocurrency** basis and report gain or loss resulting from an exchange of **cryptocurrency** for currency or other property. The Notice provides that "if the fair market value of property received in an exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain," and correspondingly, "the taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency." [23] What this means is that had I purchased my patio furniture with Bitcoin, I would have needed to make a determination of gain or loss, based on my Bitcoin basis at the time of purchase. I would also need to report any gain or loss on my income tax return. I tend to doubt that the average consumer using Bitcoin or any other convertible **cryptocurrency** is following this approach.

The type of gain or loss resulting from a virtual currency exchange generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer, similar to all exchanges involving property. [24] An exchange of a capital asset will give rise to capital gain or loss. The Notice provides the examples of stocks, bonds and other investment property as capital assets. [25] In contrast, an exchange of an ordinary asset will give rise to ordinary income or loss. The Notice provides the examples of inventory and other property held mainly for sale to customers in a trade or business as property that is not a capital asset. [26]

Do you think the IRS got this treatment right? Most tax practitioners, to the extent that they have considered it, agree that treating convertible virtual currency as property for U.S. federal income tax purposes is correct. Treating **cryptocurrency** as property makes sense in a lot of ways. It is in effect a type of digital property. It is similar to gold coins or gold bars in that it, in many cases, may have an exchange rate into U.S. dollars or other "real money," but it is not itself legal tender. We can't buy lunch with a gold bar, but we can exchange it for cash and buy lunch. However, on that note, classification as "property" for tax purposes creates confusion among those who use it more regularly, those who truly think of it as a currency akin to the U.S. dollar. My non-tax savvy millennial friends (yes, I have some) think of Bitcoin in particular as money. It looks and feels the same to them as though they were spending U.S. dollars from Apple Pay or other smartphone application that allows payment through a digital medium. In other words, they are buying lunch with Bitcoin. So, in the first instance, while treating convertible virtual currency as property theoretically makes sense, we are left with a difference in colloquial view among the general public and the legal view within the IRS.

Second, the tracking headaches that are required to properly report exchanges of **cryptocurrency** for U.S. federal income tax purposes are perhaps insurmountable to some if known and likely completely unknown to many. When treated as property, **cryptocurrency** always has a basis that must be determined and any exchange of **cryptocurrency** may trigger gain or loss. Given that **cryptocurrency** may be traded in very high frequencies, it is onerous to track this basis and report accordingly for tax purposes. One might say, well, high-frequency traders handle this; why not those in the **cryptocurrency** market? I tend to agree with that rebuttal for those in the business of **cryptocurrency**. For those simply using Bitcoin to buy lunch, I'm not sure this is an appropriate requirement. Query whether this is the correct position to take in light of these issues, or whether congressional action will be required at some point to help clarify identification of different blocks of **cryptocurrencies** sold or exchanged. Perhaps a de minimis requirement should apply (or would that ultimately be used in an abusive manner?).

Nevertheless, in and of itself, the property characterization makes sense and a basis determination must be made. To help identify tax basis for blocks of **cryptocurrency**, it may be helpful to look at similar properties, such as stock. With respect to stock, with some exception, if a taxpayer sells or transfers shares of stock in a corporation that the taxpayer purchased or acquired on different dates or at different prices, and the taxpayer does not identify the particular lot from the stock is sold or exchanged, the stock sold or transferred is charged against the earliest lot the taxpayer *59 purchased or acquired to determine the basis and holding period of the stock.[27] This is known as the first in, first out method ("FIFO"). Further, the taxpayer must determine the basis of the identical stock by averaging the cost of each share if the stock is purchased at separate times on the same calendar day in executing a single trade order, and the broker executing the trade provides a single confirmation that reports an aggregate total cost or an average cost per share.[28] However, the taxpayer may determine the basis of the stock by the actual cost per share if the taxpayer notifies the broker in writing of this intent.[29] These rules are specific to stock. In many ways, **cryptocurrency** is similar to stock in that it may be purchased in separate blocks at separate occasions without separate identification among the blocks. Because **cryptocurrency** is treated as property for U.S. federal income tax purposes, a determination of basis will have to be made among the blocks once **cryptocurrency** is sold or exchanged. It seems reasonable that a method similar to the determination for stocks may be used, such as FIFO, allowing the taxpayer to identify which block is sold in order to achieve the best tax result upon the exchange. However, there is no guidance from the IRS to date permitting this approach.

Copious similar unanswered questions remain. A few are raised below.

FBAR AND FATCA REPORTING REQUIREMENTS

Let's turn to reporting requirements that may apply to **cryptocurrency**. Notably, requirements for offshore accounts likely come into play. Various reporting requirements exist for U.S. holders of money and other assets in offshore accounts. Among those requirements is the filing requirement mandated by FinCEN on Form 114, Report of Foreign Bank and Financial Accounts ("FBAR"). An FBAR must be filed by any U.S. person that has a financial interest in or signature authority over foreign financial accounts if the aggregate value of the foreign financial accounts exceeds $10,000 USD any time during the calendar year.[30] An "account" for this purpose includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution.[31] This probably goes without saying, but this definition of "account" is very broad and could capture not only the expected financial accounts, such as bank accounts, but also hedge fund and mutual fund investments, among others.

Failure to file an FBAR can result in significant penalties. A person who is required to file an FBAR and fails to properly do so may be subject to a civil penalty of up to $10,000 per violation.[32] Moreover, a person who willfully fails to report an account or account identifying information may be subject to a civil monetary penalty equal to the greater of $100,000 or fifty percent (50%) of the balance in the account at the time of the violation.[33] This penalty would be in addition to any criminal penalties that may apply.[34]

Many **cryptocurrency** holders do not hold their **cryptocurrency** directly. Instead, they hold it through an online wallet, such as Coinbase, Inc. ("Coinbase").[35] If such wallets are considered held offshore, query whether these holders are subject to FBAR filing requirements if their account values exceeds $10,000 at any time during the calendar year. The IRS has not released any official guidance on this issue. Rod Lundquist, senior program analysis for the Small Business/Self-Employed Division, stated on June 4, 2014 that "[a]t this time, FinCEN has said Bitcoin is not reportable on the FBAR, at least for this filing season."[36] No further guidance has been promulgated. Thus, this issue remains unclear.

It is worth comparing **cryptocurrency** to other property that is required to be reported for FBAR purposes. FinCEN regulations do not address this issue. The IRS has released some guidance with respect to precious metals that could be analogized to in the **cryptocurrency** context. Under such guidance, the IRS has taken the position for FBAR purposes that generally "precious metals, precious stones or jewels held directly by a person are not reportable financial accounts for FBAR purposes."[37] Perhaps this means that other property, such as **cryptocurrency**, is not subject to FBAR reporting. However, the IRS further states in its guidance that a "reportable account relationship may exist where a foreign agency holds precious metals on deposit or provides insurance or other services as an agent of the person holding the metals."[38] By analogy, this might mean that holding a **cryptocurrency** as a passive investor does not subject the holder to an FBAR reporting requirement, but an agency acting as a **cryptocurrency** wallet that provides deposit and similar services for the holders may have an FBAR reporting requirement.[39] This is entirely unclear at this stage, however. Lacking guidance, it may be best practice for those who hold **cryptocurrency** in offshore accounts to report them in accordance with FBAR as otherwise required.

***60** Another requirement applicable to U.S. persons who hold money or other assets offshore is the Foreign Account Tax Compliance Act ("FATCA"). FATCA was enacted in 2010 as a means of reducing tax evasion through the use of offshore banks and other financial accounts. This is effected in part by requiring that foreign financial institutions and certain other non-financial foreign entities report their foreign assets held by their U.S. account holders.[40] If such foreign entities fail to comply, they are subject to certain withholding taxes on U.S. source payments made to them. In effect, Congress created an enforcement wing for protection of the U.S. fisc by requiring that these foreign banks and other foreign entities tattle on their U.S. accountholders, or suffer withholding taxes accordingly on U.S. source payments.

Further, Code Section 6038D, also enacted as part of FATCA, requires that any individual who holds any interest in a "specified foreign financial asset" must disclose such asset if the aggregate value of all such assets exceeds $50,000 (or such higher dollar amounts as may be prescribed). For this purpose, a "specified foreign financial asset" includes any financial account as well as stock or securities of a non-U.S. issuer, any financial instrument or contract held for investment that has a non-U.S. issuer or counterparty and any interest in a foreign entity.[41] The IRS has not provided guidance as to whether a specified foreign financial asset includes **cryptocurrency**.

As one might have guessed, some foreign entities chose to divest from the U.S. entirely rather than comply with the onerous requirements under FATCA.[42] Many have complied with FATCA, particularly as the applicable rules and regulations have become clearer and arguably less burdensome over time. What has not become clear is whether **cryptocurrency** should be considered a reportable asset for FATCA purposes. This issue is clearly on the IRS's radar. In November 2016, a federal court in the Northern District of California entered into an order authorizing the IRS to serve a so-called "John Doe" summons on Coinbase.[43] Per such summons, the IRS is seeking information about U.S. taxpayers who conducted transactions in a convertible virtual currency (in other words, sold cryptocurrency for U.S. dollars or another currency convertible into U.S. dollars) during the years 2013 to 2015 and the records of Americans who engaged in business with or through Coinbase. It is not a far stretch to assume this means that the IRS is considering how cryptocurrency is potentially furthering offshore tax evasion and what they should do about it. While guidance on FATCA remains nil, this summons should cause cryptocurrency users some concern to the extent that they hold such digital currencies offshore and are not reporting the same in accordance with FATCA.

LIKE KIND EXCHANGES OF CRYPTOCURRENCY

Given that cryptocurrency is treated as property for U.S. federal income tax purposes, it may have benefitted from a like kind exchange under the provisions of Code Section 1031 as in effect prior to 2018. Perhaps exchanging one Bitcoin for another Bitcoin could have been accomplished in a tax-deferred manner under Code Section 1031. Plus, remember how I mentioned that there are other cryptocurrencies aside from Bitcoin? Well, why not exchange one for another and call it tax-deferred!

It is clear that any newly completed Code Section 1031 exchanges are limited to those of real property, and so Code Section 1031 would not apply to cryptocurrency exchanges made after December 31, 2017. This is due to a recent in change law effected under the new tax act informally known as the Tax Cuts and Jobs Act. But what about exchanges that were undertaken before this new law became effective?

As a practical matter, it is unclear whether these types of tax-deferred transactions were feasible from a tax perspective, although there were traders in the cryptocurrency market effecting them and they were worth considering.[44] If a Code Section 1031 exchange was valid using cryptocurrency, an exchanger would be able to avoid gain recognition on the exchange. However, falling within the requirements for a Code Section 1031 exchange can be terribly challenging due to lack of guidance, not to mention the reporting requirements that must be met. And there is the threshold matter of how Code Section 1031 may have applied to cryptocurrency at all.

By way of background, Code Section 1031 as in effect prior to 2018 generally provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.[45] In a Code Section 1031 exchange, the basis of the property acquired in the exchange will be the same as that of *61 the property exchanged, decreased by the amount of any money[46] received by the taxpayer and increased in the amount of any gain recognized or decreased by the amount of any loss to the taxpayer that is recognized on the exchange.[47] The benefits of Code Section 1031 as in effect prior to 2018, however, do not apply to exchanges of stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests or choses in action.[48] Stocks, bonds and notes are not specifically defined for this purpose, yet it seems unlikely that cryptocurrency would be considered a stock or bond for such Code Section 1031 purposes (although, given that IRS guidance finds that digital currency should be treated as property, much like stock, this is not a foregone conclusion). Treatment as indebtedness seems unlikely. The remaining items on the exclusion list should not apply, although this result is unclear due to lack of guidance. Let's take it at face value pending further IRS or congressional guidance that cryptocurrency is property that could qualify for a like kind exchange under Code Section 1031 as in effect prior to 2018.

The question next becomes whether one cryptocurrency could have been exchanged prior to 2018 for another one under Code Section 1031's requirement that the properties be of a "like kind." Under Code Section 1031(a), the words "like kind" are not specifically defined. Does this mean "like kind" in value? Or "like kind" in form? Luckily, the regulations under Code Section 1031 provide some insight in this regard. Specifically, Treasury Regulation Section 1.1031(a)-1(b) states that as used in Code Section 1031, the words "like kind" have reference to the nature or character of the property and not to its grade or quality. The regulation goes on to explain that one kind or class of property may not, under Code Section 1031, be exchanged for a property of a different kind or class. Well, that's all well and good, but we are left to parse what might be meant by different classes. Is Bitcoin the same class of property as Ethereum, a different **cryptocurrency**? What about Litecoin, yet another different **cryptocurrency**?

Perhaps we can find more helpful guidance as we move through the regulations. Treasury Regulation Section 1.1031(a)-1(c) provides an example of an exchange of property that is of a "like kind." In the example, no gain or loss is recognized if a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose. Further, the example states that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate. Even further, the example states that no gain or loss is recognized if a taxpayer exchanges investment property and cash for investment property of a like kind. On the other hand, the regulations provide that gain or loss is recognized if, for instance, a taxpayer exchanges: (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968; or (2) a real estate mortgage for consolidated farm loan bonds. [49]

Specific rules relating to Code Section 1031 exchanges of intangible property may also shed some light on this issue. Per Treasury Regulation Section 1.1031(a)-2(c) (1), an exchange of intangible personal property qualifies under Code Section 1031 as in effect prior to 2018 only if the exchanged properties are of a like kind. The regulation clarifies that "whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or copyright) and also the nature or character of the underlying property to which the intangible personal property relates." Thus, we have essentially a two-prong test, one for the rights involved and a second for the underlying property to which the rights relate (the "Two-Prong Test").

The regulations have two simple examples to illustrate the Two-Prong Test. In the first example, a taxpayer exchanges a copyright on a novel for a copyright on a different novel. [50] This is a like kind exchange for Code Section 1031 purposes to the extent completed prior to 2018. This seems to make sense, given not only is the right the same (i.e., a copyright) but also the underlying property to which the right relates is the same (i.e., a novel). There is no discussion of the type of the novel (for example, we are left to assume that any of the Harry Potter books would be of a like kind to a historical novel for these purposes; I suppose we can accept that premise). In the second example, a taxpayer exchanges a copyright on a novel for a copyright on a song. [51] This is not a like kind exchange for Code Section 1031 purposes. Apparently, while copyrights can be exchanged under the first prong of the Two-Prong *62 Test, a song's copyright and a novel's copyright are not of sufficient like kind to meet the second prong of the Two-Prong Test.

Based on these examples, "like kind" does not speak to the extent of improvements or innovations (can we go so far to say its development?) but more to its categorization of property and its use. Thus, one might reasonably argue that exchanging one Bitcoin for another Bitcoin is an exchange of like kind for purposes of Code Section 1031 as in effect prior to 2018. [52] After all, it seems that one Bitcoin and another Bitcoin should be "of a like kind"--in fact, they are virtually identical in terms of their technology, subject to the electronic keys necessary to show proof of ownership. They include the same rights and these rights are to the same underlying type of property, and therefore this exchange appears to satisfy the Two-Prong Test and applicable guidance generally.

What about exchanges among different types of **cryptocurrency**, such as Bitcoin and Ethereum? Are two **cryptocurrencies** sufficiently similar to be of a like kind for Code Section 1031 purposes as in effect prior to 2018? Do they pass the Two-Prong Test? In one perhaps instructive example, the IRS has held that gold bullion held for investment and silver bullion held for investment are not of a like kind.[53] The IRS stated that the values of the silver bullion and the gold bullion are determined solely on the basis of their metal content.[54] Although the IRS found that gold and silver bullion have similar qualities and uses, "silver and gold are intrinsically different metals and primarily used in different ways."[55] In another instance, the IRS reviewed an exchange of U.S. gold coins that were held for investment purposes.[56] These U.S. gold coins were "numismatic-type coins;" in other words their value was "determined by their age, number minted, history, art and aesthetics, condition and metal content."[57] The U.S. gold coins were exchanged for South African Krugerrand gold coins, which were also held as an investment. These South African gold coins were "bullion-type coins," meaning their value was determined "solely on the basis of their metal content."[58] The taxpayer reported the exchange as a Code Section 1031 exchange. The IRS disagreed with the taxpayer that Code Section 1031 applies to the transaction, stating that "although the coins appear to be similar because they both contain gold, they actually represent totally different types of underlying investment."[59] Specifically, the IRS explained that the bullion-type coins (i.e., the South African Krugerrand gold coins), unlike the numismatic-type coins (i.e., the U.S. gold coins), "represent an investment in gold on world markets rather than in the coins themselves."[60] In light of these differences in character, the coins could not be exchanged under Code Section 1031(a). In contrast, in non-binding guidance, the IRS found that South African Krugerrand gold coins could be exchanged for U.S. gold bullion bars in a Code Section 1031 exchange.[61] In such case, the gold bullion bars were being held for investment purposes. The IRS that the "differences between the gold bullion bars and South African Krugerrand gold coins are primarily of size, shape and amount of gold content," and, further, that "the nature or character of the coins [and] bullion gold. . . is the same."

Based on that guidance, it seems doubtful that a taxpayer could argue that an exchange of Bitcoin for Ethereum would be an exchange of a "like kind" for purposes of Code Section 1031 as in effect prior to 2018 if the IRS chooses to look past the **cryptocurrency** aspects of Bitcoin and Ethereum and look more substantively at what is happening outside the currency aspects--particularly in light of the Two-Prong Test. This is because Bitcoin and Ethereum, while both **cryptocurrencies**, are (perhaps surprisingly to my tax colleagues!) developed and function quite differently. Bitcoin is what we might more typically think of as a **cryptocurrency**, and it was developed to act as an online currency without thought to further uses.[62] On the other hand, Ethereum is not built to only act as an online currency. Instead, it has potential uses far beyond a tender, including helping to create new types of data security, storage of data, helping to create smart programs and tools in a variety of industries, along with many other potential uses.[63] In other words, one might say that Bitcoin is an investment based in Bitcoin whereas Ethereum represents an investment in a potentially much larger market. Thus, Bitcoin and Ethereum might represent rights that are of a like kind, per the first prong of the Two-Prong Test, but they may not have rights to the same underlying property, per the second prong of the Two-Prong Test. Can these two items really be considered of a "like kind" in that case? In my view, there is some significant risk that they cannot.

Even the idea that a Bitcoin-for-Bitcoin exchange may constitute a Code Section 1031 exchange to the extent completed prior to 2018, as suggested above, may be doubtful as these technologies evolve. By way of example, on August 1, 2017, Bitcoin essentially "split" *63 into two markets: Bitcoin and "Bitcoin Cash," or "BCC."[64] This split was caused by a split from the underlying "blockchain" upon which Bitcoin operated as a technical matter,[65] and by a split among Bitcoin users regarding the degree at which Bitcoin should grow and scale over a more global matter.[66] Could Bitcoin have been exchanged for BCC in a Code Section 1031 exchange completed before 2018, or were the two **cryptocurrencies** then sufficiently different in character with respect to their underlying property not to be of a like kind? Will there be any reliable means to vet this and similar issues with respect to new **cryptocurrencies** from new and similar splits to make an appropriate determination on this issue? These questions are sure to remain until we have more definitive guidance, which is unlikely to come any time soon.

ADDITIONAL TAX CONSIDERATIONS FOR CRYPTOCURRENCY

The above provides some highlights of the tax treatment of **cryptocurrency** and the unknowns of the same. There are many more unknowns that are not addressed above. For example, dealers in securities and traders and dealers in commodities may make a mark-to-market election under Code Section 475 with respect to their securities and commodities. This election essentially allows the dealers and traders to use the inventory method of accounting for these properties and can provide significant tax benefits to those who make this election. Does this election apply to **cryptocurrency**, given it is considered property for U.S. federal income tax purposes? In another example, could **cryptocurrencies** be swapped in a commodities swap (sometimes referred to as a notional principal contract or "NPC") for purposes of Code Section 446? What about whether offshore entities holding **cryptocurrency** qualify as passive foreign investments companies under Code Section 1297 ("PFIC")? In other words, is **cryptocurrency** a passive asset for PFIC purposes? These and many other questions remain. Like so many instances in tax law, we are left to analogize to other guidance and case law, wonder about these issues in the shower and hope we made the right and best decision as advisors until reaffirmed or told otherwise by the IRS, the courts or Congress. In the meantime, I am off to buy cushions for my patio furniture, and I may just use Bitcoin in my exchange.

Footnotes

a1 SARAH-JANE MORIN is Of Counsel to Morgan Lewis, in San Francisco. She focuses her practice on representation of public and private companies, private equity funds, venture capital funds, real estate funds, portfolio companies, and real estate investment trusts in the tax aspects of complex business transactions and fund formations, including domestic and cross-border investment strategies, sponsor investment strategies, limited partner investment strategies, mergers, acquisitions, integrations, buyouts, recapitalizations, debt and equity restructurings, and ongoing operations and tax compliance issues. Additionally, she advises on international tax issues, including the tax aspects of offshore vehicles (CFC/PFIC regimes), anti-deferral rules (Subpart F), withholding, cost sharing, and transfer pricing.

1 http://www.dummies.com/personal-finance/what-is-**cryptocurrency**/.

2 https://www.nytimes.com/2015/05/30/nyregion/ross-ulbricht-creator-of-silk-road-website-is-sentenced-to-life-in-prison.html?_r=0.

3 https://www.cnbc.com/2016/05/02/bitcoin-inventor-satoshi-nakamoto-finally-revealed.html

4 Id.

5 Id

6 https://en.wikipedia.org/wiki/**Cryptocurrency**.

7 https://www.forbes.com/sites/mikemontgomery/2015/09/15/bitcoin-is-only-the-beginning-for-blockchain-technology/2/#54321ee075be; https://coinmarketcap.com/all/views/all/.

8 https://www.fincen.gov/news/news-releases/fincen-issues-guidancevirtual-currencies-and-regulatory-responsibilities; see also https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-personsadministering.

9 Id.

10 Id.

11 FinCEN has also issued additional guidance regarding **cryptocurrency**, including its January 2014 release of two administrative rulings, both regarding qualification as a money transmitter (Application of FinCEN's Regulations to Virtual Currency Mining Operations (FIN-2014-R001), https://www.fincen.gov/resources/statutes-regulations/administrative-rulings/application-fincens-regulations-virtual-0 and Application of FinCEN's Regulations to Virtual Currency Software

Development and Certain Investment Activity (FIN-2014-R002), https://www.fincen.gov/resources/statutes-regulations/administrative-rulings/application-fincens-regulations-virtual.

12 In re: Coinflip, Inc., d/b/a Derivabit, et al. Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 15-29 (Sept. 17, 2015), http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf.

13 Id.

14 IRS Notice 2014-21, 2014-16 IRB 938.

15 Id.

16 Id.

17 As noted above, although Bitcoin may be the most well-known cryptocurrency, there are in fact many other types of cryptocurrencies.

18 IRS Notice 2014-21.

19 Id.

20 Id.

21 Id., §4, Q-4.

22 Id., §4, Q-5.

23 Id., §4, Q-3.

24 Id., §4, Q-7.

25 Id.

26 Id.

27 U.S. Treas. Reg. §1.1012-1(c)(1)(i).

28 U.S. Treas. Reg. §1.1012-1(c)(1)(ii).

29 Id.

30 https://www.fincen.gov/report-foreign-bank-and-financial-accounts.

31 https://www.fincen.gov/sites/default/files/shared/FBARLine0#Item0#FilingInstructions.pdf.

32 Id.

33 Id.

34 Id.

35 See https://www.coinbase.com/?locale=en-US

36 https://www.bna.com/irs-no-bitcoin-n17179891056/

37 IRM 4.26.16.3.2 (11-06-2015), https://www.irs.gov/irm/part4/irm_04-026-016.html.

38 Id.

39 This appears to be the position taken by some tax practitioners. See, for example, https://www.forbes.com/sites/kellyphillipserb/2014/06/30/irs-says-bitcoin-not-reportable-on-fbar-for-now/#7a576297546b.

40 https://www.irs.gov/businesses/corporations/foreign-account-tax-compliance-act-fatca; see generally Code §§1471 through 1474 and the U.S. Treasury Regulations promulgated thereunder.

41 Code §6038D(b)(2).

42 See, for example, discussion of divestment in https://www.forbes.com/sites/danielmitchell/2011/12/30/obama-has-united-the-world-in-opposition-to-bad-u-s-tax-policy/#57ececc02bb3

43 In the matter of John Does, No. 3:16-cv-06658-JSC (N.D. Calif.); see also https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used.

44 See https://www.forbes.com/sites/greatspeculations/2017/08/15/cryptocurrency-traders-risk-irs-trouble-with-like-kind-exchanges/#13de44eb26a8.

45 Code §1031(a)(1). Note that gain realized on a Code §1031 exchange does need to be recognized to the extent that certain recapture provisions under the Code are implicated (namely, Code §§1245 and 1250). Code §§1245(b)(4) and 1250(d)(4).

46 In this case, by "money," I mean what we typically think of as money: coins and banknotes.

47 Code §1031(d).

48 Code §1031(a)(2).

49 Treas. Reg. §1.1031(a)-1(d).

50 Treas. Reg. §1.1031(a)-2(c)(3), Example 1.

51 Treas. Reg. §1.1031(a)-2(c)(3), Example 2.

52 This assumes that all other relevant requirements necessary for a Code §1031 exchange are met.

53 Rev. Rul. 82-166, 1982-2 C.B. 190.

54 Id.

55 Id.

56 Rev. Rul. 79-143, 1979-1 C.B. 264.

57 Id.

58 Id.

59 Id.

60 Id.

61 PLR 8117053.

62 https://www.forbes.com/sites/quora/2017/09/14/how-is-ethereum-different-from-bitcoin/#388eef37502b.

63 http://blog.bnktothefuture.com/icos-disrupting-equity-can-expect-bnktothefuture/.

64 https://www.cnbc.com/2017/08/02/bitcoin-cash-rallies-blockchain-split-digital-currency.html.

65 Id.

66 https://www.coindesk.com/coindesk-explainer-bitcoin-cash-forking-blockchain/.

32 No. 3 PRACTXL 56

(b)(5) Deliberative Process Privilege

[redacted]

From: Wrobel Christopher
To: Hanlon-Bolton Julie
Subject: FW: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry
Date: Wednesday, February 12, 2020 7:04:05 PM

FYI

From: Friedland Bruce I
Sent: Wednesday, February 12, 2020 7:00 PM
To: Cardone John V <[redacted] (b)(6) Moriarty John P <[redacted] (b)(6) Drenthe Pamela J <[redacted] (b)(6) Wrobel Christopher <[redacted] (b)(6)>; Goldstein Ronald J <[redacted] (b)(6)
Subject: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

[redacted] (b)(5) Deliberative Process Privilege

I am sure there will be more tomorrow

From: Bruce Friedland <[redacted] (b)(6)
Date: Wednesday, Feb 12, 2020, 6:51 PM
To: Friedland Bruce I <[redacted] (b)(6)
Subject: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

BY ALLYSON VERSPRILLE
Feb. 12, 2020, 6:14 PM

- Removes website language saying Fortnite, Roblox money is virtual currency
- Original wording would have subjected millions to new reporting requirement

The IRS on Wednesday pulled language from its website that would have subjected millions of users of the popular video games Fortnite and Roblox to a new disclosure requirement after Bloomberg Tax asked about it.

A recently revised attachment to Form 1040, which taxpayers use to file their annual income tax returns, asks people to answer a yes or no question on whether or not they received, sold, exchanged, or otherwise acquired a financial interest in virtual currency in 2019.

The IRS's webpage, which has since been updated, originally listed Roblox and V-bucks as examples of convertible virtual currency, alongside well-known cryptocurrencies, such as Bitcoin and Ether. Bloomberg Tax took a screenshot of that original wording. The webpage has since been revised to list Bitcoin as the only example.

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IRS website as it looked at 11:30 AM on Feb. 12.

The IRS didn't immediately respond to a request for comment.

Jerry Brito, executive director of the advocacy group Coin Center, noted this language in a Twitter post early Wednesday. He said it could result in millions of people—Roblox and Fornite combined boast upwards of 300 million users—unknowingly having an obligation to check "yes" on the IRS's new 1040 question.

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The added question on the Form 1040 is supposed to help the IRS gather information so it can more effectively crack down on people who may be dodging the taxes they owe on virtual currency transactions. This effort is aimed primarily at investors who aren't disclosing large gains from transactions involving Bitcoin and other popular cryptocurrencies.

It's unclear how having millions of people disclose their gaming currency would help achieve that goal, Brito said.

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Cashing Out?

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In comparison, Roblox does allow users who are 13 years of age or older to cash out their Robux for U.S. dollars if they have at least 100,000 Robux in their account and are members of the Roblox premium service. Roblox didn't immediately respond to a request for comment.

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"Financial regulators who have considered the status of game currencies in detail have treated them distinctly different from Bitcoin and similar virtual currencies precisely because they cannot be cashed out," the group said earlier in the day. "We think that is the appropriate approach and are hopeful that on closer consideration the IRS will correct its guidance."

To contact the reporter on this story: Allyson Versprille in Washington at averspriIle@bloombergtax.com

From: Hanlon-Bolton Julie
To: Bolton, Stuart W
Subject: FW: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry
Date: Thursday, February 13, 2020 9:49:00 AM

Julie Hanlon Bolton
Acting Deputy Chief Counsel (IT&A)
(b)(6)

From: Wrobel Christopher
Sent: Wednesday, February 12, 2020 7:04 PM
To: Hanlon-Bolton Julie
Subject: FW: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

FYI

From: Bruce Friedland (b)(6)
Date: Wednesday, Feb 12, 2020, 6:51 PM
To: Friedland Bruce I (b)(6)
Subject: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

BY ALLYSON VERSPRILLE
Feb. 12, 2020, 6:14 PM

- Removes website language saying Fortnite, Roblox money is virtual currency
- Original wording would have subjected millions to new reporting requirement

The IRS on Wednesday pulled language from its website that would have subjected millions of users of the popular video games Fortnite and Roblox to a new disclosure requirement after Bloomberg Tax asked about it.

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To contact the reporter on this story: Allyson Versprille in Washington at averspril le@bloombergtax.com

From: Hanlon-Bolton Julie
To: Moriarty John P
Subject: FW: VC Press Response
Date: Thursday, February 13, 2020 5:17:01 PM

Julie Hanlon Bolton
Acting Deputy Chief Counsel (IT&A)
[redacted] (b)(6)

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 5:01 PM
To: Hanlon-Bolton Julie
Subject: RE: VC Press Response

Julie,

Just wanted to confirm that we can send this to Bruce, or whether we need to circle back with Bill first. Thanks.

Chris

From: Cardone John V
Sent: Thursday, February 13, 2020 4:55 PM
To: Wrobel Christopher [redacted] (b)(6)>
Cc: Hanlon-Bolton Julie <[redacted] Goldstein Ronald J [redacted] (b)(6) Flax Nikole C <[redacted] (b)(6) O'Donnell Douglas W <[redacted] (b)(6) Khoury Mireille T <[redacted] (b)(6)
Subject: VC Press Response

We're good.

From: Wrobel Christopher <[redacted] (b)(6)
Sent: Thursday, February 13, 2020 4:49 PM
To: Cardone John V [redacted] (b)(6)
Cc: Hanlon-Bolton Julie [redacted] (b)(6)>; Goldstein Ronald J [redacted] (b)(6)
Subject: VC Press Response

John,

We met will Bill Paul this afternoon to discuss the response to the pending virtual currency press questions about gaming currency. [redacted] (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

[redacted]

Chris

From: Wrobel Christopher
To: Hanlon-Bolton Julie
Subject: FW: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error
Date: Thursday, February 13, 2020 3:57:14 PM

Julie,

We just received this.

From: Desmond Michael J
Sent: Thursday, February 13, 2020 3:49 PM
To: Friedland Bruce I <(b)(6)
Cc: Lemons Terry L <(b)(6); Eldridge Michelle L (b)(6)
Reynolds Jodie M (b)(6); Cullinan Thomas A
(b)(6) Moriarty John P
(b)(6) Wrobel Christopher
(b)(6)
Subject: RE: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error

Bruce,

(b)(5) Deliberative Process Privilege

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Date: Thursday, Feb 13, 2020, 3:35 PM
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Cc: Lemons Terry L <(b)(6); Eldridge Michelle L (b)(6)
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<(b)(6)
Subject: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error

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Feb. 13, 2020, 2:26 PM

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To contact the reporter on this story: Allyson Versprille in Washington at aversprille@bloombergtax.com

From: Hanlon-Bolton Julie
To: Moriarty John P
Subject: FW: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error
Date: Thursday, February 13, 2020 4:03:00 PM

FYI. Chris, Ron, and I met with Bill Paul just now [redacted] (b)(5) Deliberative Process Privilege The team is working with john Cardone on this issue.
Thanks,
Julie

Julie Hanlon Bolton
Acting Deputy Chief Counsel (IT&A)
[redacted] (b)(6)

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 3:57 PM
To: Hanlon-Bolton Julie
Subject: FW: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error

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Cc: Lemons Terry L [redacted] (b)(6); Eldridge Michelle L [redacted] (b)(6) Reynolds Jodie M [redacted] (b)(6) Cullinan Thomas A [redacted] (b)(6) Moriarty John P [redacted] (b)(6) Wrobel Christopher [redacted] (b)(6)
Subject: RE: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error

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[redacted] (b)(5) Deliberative Process Privilege

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aversprille@bloombergtax.com

From: Moriarty John P
To: Friedland Bruce I
Subject: RE: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry
Date: Thursday, February 13, 2020 10:04:00 AM

Thanks, Bruce. And, oh yes, there will be more tomorrow.

From: Friedland Bruce I
Sent: Wednesday, February 12, 2020 7:00 PM
To: Cardone John V; Moriarty John P; Drenthe Pamela J; Wrobel Christopher; Goldstein Ronald J
Subject: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

(b)(5) Deliberative Process Privilege [redacted]

I am sure there will be more tomorrow

From: Bruce Friedland [redacted] (b)(6)
Date: Wednesday, Feb 12, 2020, 6:51 PM
To: Friedland Bruce I [redacted] (b)(6)
Subject: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

BY ALLYSON VERSPRILLE
Feb. 12, 2020, 6:14 PM

- Removes website language saying Fortnite, Roblox money is virtual currency
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The IRS didn't immediately respond to a request for comment.

Jerry Brito, executive director of the advocacy group Coin Center, noted this language in a Twitter post early Wednesday. He said it could result in millions of people Roblox and Fornite combined boast upwards of 300 million users—unknowingly having an obligation to check "yes" on the IRS's new 1040 question.

"I think a lot of people aren't going to know that they have to answer 'yes' so they're going to answer 'no,'" he told Bloomberg Tax.

The added question on the Form 1040 is supposed to help the IRS gather information so it can more effectively crack down on people who may be dodging the taxes they owe on virtual currency transactions. This effort is aimed primarily at investors who aren't disclosing large gains from transactions involving Bitcoin and other popular cryptocurrencies.

It's unclear how having millions of people disclose their gaming currency would help achieve that goal, Brito said.

A spokesperson for Fortnite creator Epic Games Inc. said by email that characterizing V-bucks as a convertible virtual currency didn't make sense.

Cashing Out?

On its website the IRS defines a convertible virtual currency as one that has an equivalent value in real currency or acts as a substitute for real currency. It also says these types of virtual currencies can be "digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, euros, and other real or virtual currencies."

The Epic Games spokesperson said V-bucks shouldn't fit that definition. "V-Bucks cannot 'be digitally traded between users,' nor can they be 'exchanged into, U.S. dollars, Euros, and other real or virtual currencies,' " the spokesperson said.

In comparison, Roblox does allow users who are 13 years of age or older to cash out their Robux for U.S. dollars if they have at least 100,000 Robux in their account and are members of the Roblox premium service. Roblox didn't immediately respond to a request for comment.

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From: Hanlon-Bolton Julie
To: Wrobel Christopher; Moriarty John P
Subject: RE: ARTICLE: CNN - IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns
Date: Thursday, February 13, 2020 2:39:00 PM

(b)(5) Deliberative Process Privilege [redacted]

Julie Hanlon Bolton
Acting Deputy Chief Counsel (IT&A)
(b)(6) [redacted]

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 1:44 PM
To: Moriarty John P; Hanlon-Bolton Julie
Subject: FW: ARTICLE: CNN - IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns

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From: Friedland Bruce I
Sent: Thursday, February 13, 2020 1:26 PM
To: Wrobel Christopher [redacted] (b)(6); Goldstein Ronald J
[redacted] (b)(6)
Subject: ARTICLE: CNN - IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns

IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns

CNN

Washington, DC (CNN Business) For months leading up to this tax season, a section of the IRS's website advised players of Fortnite, the popular online video game, that their use of in-game virtual currency could be subject to federal taxes.

The little-noticed provision, which dated back at least to October according to the cached version of an IRS webpage on Archive.org, appeared to mark the first time the agency has ruled on video game currencies, including Fortnite's V-bucks, purchased with real dollars. By applying the same policy to in-game money that it enforces on bitcoin, ether and other cryptocurrencies, the IRS guide seemed poised to affect millions of gamers — or their parents.

But on Wednesday, the IRS scrubbed all mentions of the in-game currency from the webpage after questions from CNN and other outlets about the policy. Despite the sudden deletion, experts believe that transactions involving video game currencies will still need to be reported under a new question the IRS is including this year on tax forms. Just because the IRS deleted the language, they said, does not resolve questions about how the IRS plans to treat video game currencies.

The IRS didn't respond to multiple requests for comment, and did not respond when CNN asked for a clear statement about the tax treatment of video game currencies.

The IRS's unexplained changes only add to confusion about how it is handling tax filings for virtual currencies -- and which digital products are lumped into the category. "[The] definition of virtual currency in IRS guidance would still encompass these," Jerry Brito, executive director at the Coin Center, a virtual currency think tank, wrote on Twitter after the changes. "I don't think they realized the consequences of their 1040 question."

The agency has long reminded Americans that virtual currency is treated like property for tax purposes. When Americans buy bitcoin, for example, they need to keep track of how much they paid for it. When they sell, they need to report any appreciation in value and pay taxes on those capital gains (and can claim a loss if there were realized losses). Using bitcoin to buy goods and services, even a coffee, is still considered a sale of property and potentially a taxable event. The IRS published a landmark policy guidance in 2014 laying out the details, and another update last year.

Last fall, the IRS appeared to clarify that the same tax policy also applies to video game currencies.
"Bitcoin, Ether, Roblox, and V-bucks are a few examples of a convertible virtual currency," the IRS said on the webpage, prior to removing the language on Wednesday. The IRS did not appear to limit the types of video game currencies that may be covered under the policy.
Modern video games have increasingly turned to sales of virtual currency — which can then be used to purchase in-game costumes, weapon skins and randomized loot boxes — as a form of revenue.

Popular online games such as Apex Legends, PlayerUnknown's Battlegrounds and League of Legends all use in-game currencies and are likely subject to the rule, said Neeraj Agrawal, a spokesman for the Coin Center.

"Every major online game has some kind of in-game economy at this point," he said. "It's a very popular mechanic."

Fortnite in particular has become an internet sensation, amassing $1.8 billion in revenue last year, according to industry estimates. Last March, Fortnite's publisher, Epic Games, announced the title had nearly 250 million registered players around the globe.

Following the IRS's surgical edits this week, bitcoin is the only remaining example of a virtual currency offered on the agency webpage. But just because V-bucks have been removed does not mean the IRS regards all transactions in the currency as tax-exempt.

"They probably removed it because it's not particularly accurate, or had some error," said Mark Steber, chief tax officer at the tax prep company Jackson Hewitt. "In the law, if it's not specifically exempted, then it's taxable. Nothing is exempt from taxation which is not excluded from the law."

Taxpayers who had virtual currency transactions in 2019 will need to fill out Schedule 1 with their Form 1040, according to the IRS's 1040 instructions. The first question on Schedule 1: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

According to the instructions for Schedule 1, taxpayers will need to answer yes if they have engaged in a transaction involving virtual currency; if they have received any amount of virtual currency for free; have exchanged virtual currency for goods or services; have sold virtual currency; or have exchanged virtual currency for other property, including other virtual currency.

The reversal came the same day that the Government Accountability Office published a report calling on the IRS to provide "clarified guidance" on virtual currencies.

Some tax experts said the agency is simply struggling to apply time-honored tax principles to novel technologies.

"The IRS is trying to communicate that an accretion of value ... will trigger a taxable event, whether you are using the currency to buy a tangible item or to acquire a virtual item," said Mary Baker, who leads the tax policy practice at the law firm K&L Gates in Washington. "How to keep track of these transactions and their taxable effect is an issue that Congress and the Treasury Department both are grappling with."

Just because you may need to answer "yes" to the question on Schedule 1 does not necessarily mean you need to fill out anything else, Steber said. It depends on your personal situation. But some may need to report capital gains stemming from their virtual currency transactions on other forms.

"This question is an indicator that more is likely coming — more guidance, more rules, more requirements, more oversight and monitoring by the IRS," he said. "It's no longer something that's going to live in the background shadows. There's too much money there."

Although there's much that's still unsettled about how to track virtual currency transactions — and who should be responsible for it — Baker said the onus is still on taxpayers to figure out whether they owe the IRS and to fill out an accurate tax return, at least for now.

From:	Desmond Michael J
To:	Friedland Bruce I
Cc:	Lemons Terry L; Eldridge Michelle L; Reynolds Jodie M; Cullinan Thomas A; Moriarty John P; Wrobel Christopher
Subject:	RE: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error
Date:	Thursday, February 13, 2020 3:49:10 PM

Bruce,

(b)(5) Deliberative Process Privilege [redacted]

Copying John and Chris to weigh in for accuracy.

From: Friedland Bruce I <[redacted] (b)(6)
Date: Thursday, Feb 13, 2020, 3:35 PM
To: Desmond Michael J <[redacted] (b)(6)
Cc: Lemons Terry L <[redacted] (b)(6) Eldridge Michelle L <[redacted] (b)(6) Reynolds Jodie M <[redacted] (b)(6) Cullinan Thomas A <[redacted] (b)(6)
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To: Cardone John V; Moriarty John P; Drenthe Pamela J; Wrobel Christopher; Goldstein Ronald J
Subject: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry
Date: Wednesday, February 12, 2020 6:59:39 PM

(b)(5) Deliberative Process Privilege [redacted]

I am sure there will be more tomorrow

From: Bruce Friedland [redacted] (b)(6)
Date: Wednesday, Feb 12, 2020, 6:51 PM
To: Friedland Bruce I [redacted] (b)(6)
Subject: Article: Gamers Rich in Virtual Cash Freed from IRS Reporting Worry

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BY ALLYSON VERSPRILLE
Feb. 12, 2020, 6:14 PM

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IRS website as it looked at 11:30 AM on Feb. 12.

The IRS didn't immediately respond to a request for comment.

Jerry Brito, executive director of the advocacy group Coin Center, noted this language in a Twitter post early Wednesday. He said it could result in millions of people—Roblox and Fornite combined boast upwards of 300 million users—unknowingly having an obligation to check "yes" on the IRS's new 1040 question.

"I think a lot of people aren't going to know that they have to answer 'yes' so they're going to answer 'no,'" he told Bloomberg Tax.

The added question on the Form 1040 is supposed to help the IRS gather information so it can more effectively crack down on people who may be dodging the taxes they owe on virtual currency transactions. This effort is aimed primarily at investors who aren't disclosing large gains from transactions involving Bitcoin and other popular cryptocurrencies.

It's unclear how having millions of people disclose their gaming currency would help achieve that goal, Brito said.

A spokesperson for Fortnite creator Epic Games Inc. said by email that characterizing V-bucks as a convertible virtual currency didn't make sense.

Cashing Out?

On its website the IRS defines a convertible virtual currency as one that has an equivalent value in real currency or acts as a substitute for real currency. It also says these types of virtual currencies can be "digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, euros, and other real or virtual currencies."

The Epic Games spokesperson said V-bucks shouldn't fit that definition. "V-Bucks cannot 'be digitally traded between users,' nor can they be 'exchanged into, U.S. dollars, Euros, and other real or virtual currencies,' " the spokesperson said.

In comparison, Roblox does allow users who are 13 years of age or older to cash out their Robux for U.S. dollars if they have at least 100,000 Robux in their account and are members of the Roblox premium service. Roblox didn't immediately respond to a request for comment.

Users can also use third-party online marketplaces to coordinate the sale of gaming currencies for real money, but those transactions aren't backed or organized by the game creators.

"Game economies are typically closed economies where currencies cannot be cashed out or traded," the Entertainment Software Association said in a statement.
at
"Financial regulators who have considered the status of game currencies in detail have treated them distinctly different from Bitcoin and similar virtual currencies precisely because they cannot be cashed out," the group said earlier in the day. "We think that is the appropriate approach and are hopeful that on closer consideration the IRS will correct its guidance."

To contact the reporter on this story: Allyson Versprille in Washington
at aversprille@bloombergtax.com

From: Desmond Michael J
To: Friedland Bruce I; Cullinan Thomas A; Paul William M
Cc: Lemons Terry L; Eldridge Michelle L; Reynolds Jodie M; Moriarty John P; Flax Nikole C
Subject: RE: MEDIA INQUIRY: Virtual Currency and Video Game "dollars"
Date: Thursday, February 13, 2020 2:31:09 PM

FYI, at the TCPI conference today a number of trade reporters peppered me with questions on this. My response was limited - we were informed of the issue and quickly changed the web site, don't read too much into it. Lots of questions about whether we're doing guidance, etc.

Mike

From: Friedland Bruce I <[redacted] (b)(6)>
Date: Wednesday, Feb 12, 2020, 4:56 PM
To: Cullinan Thomas A <[redacted] (b)(6)>, Desmond Michael J <[redacted] (b)(6)>, Paul William M [redacted] (b)(6)
Cc: Lemons Terry L [redacted] (b)(6), Eldridge Michelle L [redacted] (b)(6), Reynolds Jodie M [redacted] (b)(6), Moriarty John P <[redacted] (b)(6)
Subject: MEDIA INQUIRY: Virtual Currency and Video Game "dollars"

CNN and Bloomberg came in on an SBSE web page on a tip from the VC industry that our web page meant that video gamers would have to make sure they checked the new box on the 1040 if they received game "v-bucks." [redacted] (b)(5) Deliberative Process Privilege

Bruce

[redacted] (b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

From: Wrobel Christopher
To: Paul William M
Cc: Hanlon-Bolton Julie; Kribell Wendy L; Goldstein Ronald J; Moriarty John P
Subject: Form 1040 Instructions
Date: Thursday, February 13, 2020 7:31:47 PM

Bill,

As you requested, following is the language from the 2019 Form 1040 Instructions that pertains to virtual currency. [redacted] Thanks.

(b)(5) Deliberative Process Privilege

Virtual Currency

If, in 2019, you engaged in any transaction involving virtual currency, check the "Yes" box next to the question on virtual currency at the top of Schedule 1. A transaction involving virtual currency includes:

The receipt or transfer of virtual currency for free (without providing any consideration), including from an air-drop or following a hard fork;

An exchange of virtual currency for goods or services;

A sale of virtual currency; and

An exchange of virtual currency for other property, including for another virtual currency.

If you disposed of any virtual currency that was held as a capital asset, use Form 8949 to figure your capital gain or loss and report it on Schedule D (Form 1040 or 1040-SR).

If you received any virtual currency as compensation for services or disposed of any virtual currency that you held for sale to customers in a trade or business, you must report the income as you would report other income of the same type (for example, W-2 wages on Form 1040 or 1040-SR, line 1, or inventory or services from Schedule C on Schedule 1).

If, in 2019, you have not engaged in any transaction involving virtual currency, and you don't otherwise have to file Schedule 1, you don't have to do any-thing further. If you otherwise have to file Schedule 1, check the "No" box.
For more information, go to *IRS.gov/ virtualcurrencyfaqs*

From: Wrobel Christopher
To: Moriarty John P; Hanlon-Bolton Julie
Subject: FW: Virtual Currency
Date: Friday, February 14, 2020 2:04:53 PM

John and Julie,

[redacted] (b)(5) Deliberative Process Privilege

Chris

From: Cardone John V
Sent: Friday, February 14, 2020 1:54 PM
To: Goldstein Ronald J <[redacted] (b)(6) Wrobel Christopher <[redacted] (b)(6)
Subject: Virtual Currency

This is the statement that went to the reporters. [redacted] (b)(5) Deliberative Process Privilege

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From: Friedland Bruce I <[redacted] (b)(6)
Sent: Friday, February 14, 2020 1:48 PM
To: Cardone John V <[redacted] (b)(6)
Subject: FW: IRS Statement on Changes to Virtual Currency Web Page

Here is the statement that went to four or five reporterS

From: Friedland Bruce I <[redacted] (b)(6)
Date: Friday, Feb 14, 2020, 12:40 PM
Subject: IRS Statement on Changes to Virtual Currency Web Page

<u>IRS Statement</u>

The IRS recognizes that the language on our page potentially caused concern for some taxpayers. We have changed the language in order to lessen any confusion. Transacting in virtual currencies as part of a game that do not leave the game environment (virtual currencies that are not convertible) would not require a taxpayer to indicate this on their tax return.

From:	Moriarty John P
To:	Hanlon-Bolton Julie
Subject:	RE: NYTimes
Date:	Thursday, February 13, 2020 10:08:19 AM
Attachments:	image001.png

No problem. I'll be on-line every now and then today between meetings and a trip to Motor Vehicles to get my REAL ID.

From: Hanlon-Bolton Julie
Sent: Thursday, February 13, 2020 10:07 AM
To: Moriarty John P
Subject: RE: NYTimes

Thanks, John.

From: Moriarty John P < [redacted] (b)(6)
Date: Thursday, Feb 13, 2020, 10:02 AM
To: Hanlon-Bolton Julie [redacted] (b)(6)
Subject: FW: NYTimes

From: Desmond Michael J
Sent: Thursday, February 13, 2020 10:01 AM
To: Zuba Kathryn A; Wrobel Christopher
Cc: Moriarty John P; Tonuzi Drita
Subject: FW: NYTimes

Kathy and Chris,

FYI on VC reporting if you have not seen this. I asked Drita to schedule some time next week to discuss status of the 6045 project [redacted] (b)(5) Deliberative Process Privilege

Thanks,

Mike

From: Bohls Dawn E
Sent: Thursday, February 13, 2020 9:55 AM
To: Desmond Michael J
Cc: Tonuzi Drita
Subject: RE: NYTimes

Mike –

I've attached the requested article. Please let me know if I can be of further assistance.

Regards,
Dawn E. Bohls
Reference Librarian
CC:FM:LIB
1111 Constitution Ave.
Washington, DC 20224
Tel. [redacted] (b)(6) (Direct) | **Ref. Desk** [redacted] (b)(6) **(as of 9/12/2019)**

From: Desmond Michael J
Sent: Thursday, February 13, 2020 9:47 AM
To: Bohls Dawn E [redacted] (b)(6)
Cc: Tonuzi Drita <[redacted]
Subject: NYTimes

Dawn,

Could you pull and send to me/Drita the New York Times article from this morning reporting on the Secretary's testimony yesterday about cryptocurrency reporting?

Thanks,

Mike

Michael J. Desmond
IRS Chief Counsel
[redacted] (b)(6)

From: Wrobel Christopher
To: Paul William M
Cc: Hanlon-Bolton Julie; Kribell Wendy L; Goldstein Ronald J; Moriarty John P
Subject: Form 1040 Instructions
Date: Thursday, February 13, 2020 7:31:47 PM

Bill,

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A sale of virtual currency; and

An exchange of virtual currency for other property, including for another virtual currency.

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If, in 2019, you have not engaged in any transaction involving virtual currency, and you don't otherwise have to file Schedule 1, you don't have to do any-thing further. If you otherwise have to file Schedule 1, check the "No" box.
For more information, go to *IRS.gov/ virtualcurrencyfaqs*

From: Hanlon-Bolton Julie
To: Moriarty John P
Subject: FW: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error
Date: Thursday, February 13, 2020 4:03:10 PM

FYI. Chris, Ron, and I met with Bill Paul just now. [redacted] (b)(5) Deliberative Process Privilege

Thanks,
Julie

Julie Hanlon Bolton
Acting Deputy Chief Counsel (IT&A)
[redacted] (b)(6)

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 3:57 PM
To: Hanlon-Bolton Julie
Subject: FW: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error

Julie,

We just received this.

From: Desmond Michael J
Sent: Thursday, February 13, 2020 3:49 PM
To: Friedland Bruce I <[redacted] (b)(6)
Cc: Lemons Terry L <[redacted] (b)(6) Eldridge Michelle L <[redacted] (b)(6) Reynolds Jodie M <[redacted] (b)(6) Cullinan Thomas A <[redacted] (b)(6) Moriarty John P <[redacted] (b)(6) Wrobel Christopher <[redacted] (b)(6)
Subject: RE: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error

Bruce,

[redacted] (b)(5) Deliberative Process Privilege

Copying John and Chris to weigh in for accuracy.

From: Friedland Bruce I (b)(6)
Date: Thursday, Feb 13, 2020, 3:35 PM
To: Desmond Michael J (b)(6)
Cc: Lemons Terry L (b)(6), Eldridge Michelle L (b)(6) Reynolds Jodie M (b)(6) Cullinan Thomas A (b)(6)
Subject: Bloomberg: Calling Fortnite Cash a Virtual Currency Was an IRS Error

Mike,

CNN has come in to confirm your remarks in the story below. Any concerns with the report below? I'm happy to confirm.

Bruce
IRS Media Relations

Calling Fortnite Cash a Virtual Currency Was an IRS Error

Feb. 13, 2020, 2:26 PM

IRS Chief Counsel Michael Desmond indicated that the inclusion of the video game currencies was a mistake, though he offered no insight on how they ended up alongside Bitcoinon the list of examples.

"It was corrected and that was done quickly—as soon as it was brought to our attention," Desmond told reporters Thursday at a Tax Council Policy Institute conference in Washington.

The IRS has been focused on curbing cryptocurrency tax evasion. Last fall the agencyreleased an updated Form 1040, which is used to report income, that for the first time asked taxpayers if theyhad received, sold, exchanged, or otherwise acquired a financial interest in a virtual currency.

Fortnite and Roblox, like many other online video games, allow players to earn orpurchase in-game currencies that are used to customize and upgrade their characters.

Jerry Brito, executive director of the advocacy group Coin Center, said Wednesday that labeling in-game currencies as convertible virtual currency could unknowingly subject millions of people to new IRS reporting requirements based on the agency's website. Even though the IRS pulled the language from the website, Brito said he is unsure whether that means people with in-game currency are in the clear.

Desmond demurred when asked to confirm that gamers wouldn't need to mark 'yes' to the new 1040 question, but said addressing gaming currencies in the virtual currency context isn't a major focus for the agency right now.

"I am not even looking into that. So I'm not saying one way or another. I think I'dbe getting ahead of myself if I said anything," Desmond said. "Read the website. We posted a correction yesterday and I kind of leave it at that."

To contact the reporter on this story: Allyson Versprille in Washington at aversprille@bloomberqtax.com

From: Goldstein Ronald J
To: Paul William M
Cc: Kribell Wendy L; Moriarty John P; Hanlon-Bolton Julie; Wrobel Christopher
Subject: FW: Virtual Currency
Date: Friday, February 14, 2020 8:38:21 AM

Good morning Bill. I see you are not copied on this email chain. Please let me know if you would like to discuss.

Ron Goldstein
STR - CC:ITA:B4
202.317.4887

From: Cardone John V
Sent: Friday, February 14, 2020 7:50 AM
To: Friedland Bruce I (b)(6)
Cc: Wrobel Christopher (b)(6); Goldstein Ronald J (b)(6); Lemons Terry L (b)(6); Flax Nikole C (b)(6); Drenthe Pamela J (b)(6); Eldridge Michelle L (b)(6); Reynolds Jodie M (b)(6)
Subject: Virtual Currency

The Chief Counsel is OK with the statement that you wrote Wednesday, with the suggested edit below. Can you move forward with this please?

From: Desmond Michael J (b)(6)
Sent: Thursday, February 13, 2020 9:33 PM
To: Flax Nikole C (b)(6)
Cc: Cullinan Thomas A (b)(6); Cardone John V (b)(6); O'Donnell Douglas W (b)(6)
Subject: RE: Virtual Currency

Nikole,
With a minor suggested change (in bold below), I am okay with the plain language.
Thanks,
Mike

(b)(5) Deliberative Process Privilege

From: Flax Nikole C
Sent: Thursday, February 13, 2020 8:37 PM
To: Desmond Michael J
Cc: Cullinan Thomas A; Cardone John V; O'Donnell Douglas W
Subject: RE: Virtual Currency

I am sending what I understand to be the versions of language floating around. I know we want to be precise, but think we may just want to cut this off as quickly as possible and stick with the more plain-language version. Does that give you concern? Thanks

(b)(5) Deliberative Process Privilege

From: Desmond Michael J (b)(6)
Sent: Thursday, February 13, 2020 5:57 PM
To: Flax Nikole C (b)(6)
Cc: Cullinan Thomas A (b)(6); Cardone John V (b)(6)
Subject: Virtual Currency

Nikole,

I understand IT&A is working with LB&I to address the questions swirling around on virtual currency and video games. I spoke to the CIR in passing, he has seen articles/e-mails.

(b)(5) Deliberative Process Privilege

Thanks,

Mike

Michael J. Desmond
IRS Chief Counsel

(b)(6)

From: Tackney Stephen B
To: Moriarty John P
Subject: FW: GAO report re: virtual currency -- report issued
Date: Thursday, February 13, 2020 10:21:28 AM

(b)(5) Deliberative Process Privilege [redacted]

Thanks –
Stephen

From: McNally William L
Sent: Wednesday, February 12, 2020 6:42 PM
To: Richards John B; Green Lauson C; Shepherd Neil D
Cc: Gernstein Sydney L; Fernandez Catherine L; Tackney Stephen B
Subject: RE: GAO report re: virtual currency -- report issued

We did not provide input on the GAO report.

(b)(5) Deliberative Process Privilege [redacted]

Best,

Will

From: Richards John B <[redacted] (b)(6)
Sent: Wednesday, February 12, 2020 6:21 PM
To: Green Lauson C <[redacted] (b)(6) Shepherd Neil D [redacted] (b)(6) McNally William L [redacted]>
Cc: Gernstein Sydney L <[redacted] (b)(6)>; Fernandez Catherine L <[redacted] (b)(6) Tackney Stephen B <[redacted]
Subject: RE: GAO report re: virtual currency -- report issued

Will, were we involved in this at all? I don't think we were.

From: Green Lauson C
Sent: Wednesday, February 12, 2020 5:57 PM
To: Shepherd Neil D <[redacted] (b)(6)>; Richards John B [redacted] (b)(6); McNally William L <[redacted] (b)(6)
Cc: Gernstein Sydney L <[redacted] (b)(6)>; Fernandez Catherine L

(b)(6)

Subject: GAO report re: virtual currency -- report issued

GAO has issued its audit report re: "Virtual Currencies- Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance." https://www.gao.gov/assets/710/704573.pdf

I don't see that we (CC:EEE) were officially included on the team for this audit, but let me know if we provided some input to SBSE, etc. during the audit. There's no mention of "compensation" using virtual currency in the report but there are a few mentions of using virtual currency to pay for "goods and services." Presumably, for CC, this was led by ITA/Chris Wrobel, etc.

There are four recommendations, including three to IRS and one to FinCEN (however, note that the one to FinCEN includes coordination with the IRS):

1. The **Commissioner of Internal Revenue** should update the FAQs issued in 2019 to include a statement that the FAQs may serve as a source of general information but cannot be relied upon by taxpayers as authoritative since they are not binding on IRS. (Recommendation 1)
2. The **Commissioner of Internal Revenue** should take steps to increase third-party reporting on taxable transactions involving virtual currency, which could include clarifying IRS's interpretation of existing third-party reporting requirements under the Internal Revenue Code and Treasury Regulations, or pursuing statutory or regulatory changes. (Recommendation 2)
3. The **Commissioner of Internal Revenue** should clarify the application of reporting requirements under FATCA to virtual currency. (Recommendation 3)
4. **The Director of FinCEN**, *in coordination with IRS as appropriate*, should make a statement about the application of foreign account reporting requirements under the Bank Secrecy Act to virtual currency readily available to the public. (Recommendation 4)

From: Friedland Bruce I
To: Cullinan Thomas A; Desmond Michael J; Paul William M
Cc: Lemons Terry L; Eldridge Michelle L; Reynolds Jodie M; Moriarty John P
Subject: MEDIA INQUIRY: Virtual Currency and Video Game "dollars"
Date: Wednesday, February 12, 2020 4:56:32 PM

CNN and Bloomberg came in on an SBSE web page on a tip from the VC industry that our web page meant that video gamers would have to make sure they checked the new box on the 1040 if they received game “v-bucks.”

(b)(5) Deliberative Process Privilege

Bruce

(b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

From: Wrobel Christopher
To: Moriarty John P; Hanlon-Bolton Julie
Subject: FW: DRAFT STATEMENT: Changes to the Virtual Currency Page
Date: Wednesday, February 12, 2020 5:09:27 PM

Just received this from Media Affairs. They are proposing this as a response.

From: Friedland Bruce I
Sent: Wednesday, February 12, 2020 4:39 PM
To: Drenthe Pamela J (b)(6); Cardone John V (b)(6) Stiernagle Bryan R (b)(6) Goldstein Ronald J (b)(6) Wrobel Christopher
Cc: Lemons Terry L (b)(6) Eldridge Michelle L (b)(6); Reynolds Jodie M (b)(6)
Subject: DRAFT STATEMENT: Changes to the Virtual Currency Page

(b)(5) Deliberative Process Privilege

Bruce

(b)(5) Deliberative Process Privilege

(b)(5) Deliberative Process Privilege

From: Paul William M
To: Wrobel Christopher
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject: RE: Virtual Currency
Date: Thursday, February 13, 2020 5:46:13 PM

Chris, (b)(5) Deliberative Process Privilege

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 5:30 PM
To: Paul William M
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject: Virtual Currency

Bill,

Following is the language we drafted regarding the virtual currency gaming issue that we discussed this afternoon. John Cardonne (b)(5) Deliberative Process Privilege Please let us know if you have any edits, and we will send it to Media Affairs. Thanks.

(b)(5) Deliberative Process Privilege

Chris

From:	Wrobel Christopher
To:	Paul William M
Cc:	Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject:	RE: Virtual Currency
Date:	Thursday, February 13, 2020 6:06:34 PM

Bill,

(b)(5) Deliberative Process Privilege [redacted]

Thanks.

Chris

From: Paul William M
Sent: Thursday, February 13, 2020 5:46 PM
To: Wrobel Christopher <[redacted] (b)(6)>
Cc: Hanlon-Bolton Julie <[redacted] (b)(6)>; Goldstein Ronald J <[redacted] (b)(6)>; Kribell Wendy L <[redacted] (b)(6)>; Moriarty John P <[redacted] (b)(6)>
Subject: RE: Virtual Currency

Chris, [redacted]

(b)(5) Deliberative Process Privilege

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 5:30 PM
To: Paul William M
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
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(b)(5) Deliberative Process Privilege

Chris

From: Paul William M
To: Wrobel Christopher
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject: RE: Virtual Currency
Date: Friday, February 14, 2020 8:33:00 AM

[redacted] (b)(5) Deliberative Process Privilege

From: Wrobel Christopher
Sent: Thursday, February 13, 2020 6:07 PM
To: Paul William M
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject: RE: Virtual Currency

Bill,

[redacted] (b)(5) Deliberative Process Privilege

Thanks.

Chris

From: Paul William M
Sent: Thursday, February 13, 2020 5:46 PM
To: Wrobel Christopher <[redacted] (b)(6)
Cc: Hanlon-Bolton Julie <[redacted] (b)(6) Goldstein Ronald J

[redacted] (b)(6); Kribell Wendy L
[redacted] (b)(6); Moriarty John P [redacted] (b)(6)
Subject: RE: Virtual Currency

Chris, [redacted] (b)(5) Deliberative Process Privilege

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[redacted] (b)(5) Deliberative Process Privilege

Chris

From: Hanlon-Bolton Julie
To: Wrobel Christopher; Moriarty John P
Subject: RE: Virtual Currency
Date: Tuesday, February 18, 2020 10:15:18 AM

[redacted] (b)(5) Deliberative Process Privilege

Julie

Julie Hanlon Bolton
Acting Deputy Chief Counsel (IT&A)
[redacted] (b)(6)

From: Wrobel Christopher
Sent: Friday, February 14, 2020 2:05 PM
To: Moriarty John P; Hanlon-Bolton Julie
Subject: FW: Virtual Currency

John and Julie,

We just heard back from John Cardonne. [redacted] (b)(5) Deliberative Process Privilege Thanks.

Chris

From: Cardone John V
Sent: Friday, February 14, 2020 1:54 PM
To: Goldstein Ronald J [redacted] (b)(6); Wrobel Christopher [redacted] (b)(6)
Subject: Virtual Currency

This is the statement that went to the reporters. [redacted] (b)(5) Deliberative Process Privilege

From: Friedland Bruce I [redacted] (b)(6)
Sent: Friday, February 14, 2020 1:48 PM
To: Cardone John V [redacted] (b)(6)
Subject: FW: IRS Statement on Changes to Virtual Currency Web Page

Here is the statement that went to four or five reporterS

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Date: Friday, Feb 14, 2020, 12:40 PM
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The IRS recognizes that the language on our page potentially caused concern for some taxpayers. We have changed the language in order to lessen any confusion. Transacting in virtual currencies as part of a game that do not leave the game environment (virtual currencies that are not convertible) would not require a taxpayer to indicate this on their tax return.

From: Wrobel Christopher
To: Hanlon-Bolton Julie; Moriarty John P
Cc: Goldstein Ronald J
Subject: RE: Virtual Currency
Date: Friday, February 14, 2020 9:38:31 AM

FYI. (b)(5) Deliberative Process Privilege

Chris

From: Cardone John V
Sent: Friday, February 14, 2020 7:50 AM
To: Friedland Bruce I <(b)(6)
Cc: Wrobel Christopher <(b)(6)>; Goldstein Ronald J (b)(6) Lemons Terry L <(b)(6) Flax Nikole C <(b)(6) Drenthe Pamela J <(b)(6); Eldridge Michelle L <(b)(6)>; Reynolds Jodie M <(b)(6)
Subject: Virtual Currency

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Sent: Thursday, February 13, 2020 9:33 PM
To: Flax Nikole C <(b)(6)
Cc: Cullinan Thomas A (b)(6) Cardone John V <(b)(6) O'Donnell Douglas W <(b)(6)
Subject: RE: Virtual Currency

Nikole,
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Thanks,
Mike

(b)(5) Deliberative Process Privilege

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Sent: Thursday, February 13, 2020 8:37 PM
To: Desmond Michael J
Cc: Cullinan Thomas A; Cardone John V; O'Donnell Douglas W
Subject: RE: Virtual Currency

(b)(5) Deliberative Process Privilege

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Sent: Thursday, February 13, 2020 5:57 PM
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Subject: Virtual Currency

Nikole,

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(b)(5) Deliberative Process Privilege

Thanks,

Mike

Michael J. Desmond
IRS Chief Counsel
(b)(6)
[redacted]

From: Wrobel Christopher
To: Paul William M
Cc: Hanlon-Bolton Julie; Goldstein Ronald J; Kribell Wendy L; Moriarty John P
Subject: Virtual Currency
Date: Thursday, February 13, 2020 5:30:30 PM

Bill,

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(b)(5) Deliberative Process Privilege

Chris

Withheld pursuant to exemption

(b)(5) Deliberative Process Privilege

of the Freedom of Information and Privacy Act

Withheld pursuant to exemption

(b)(5) Deliberative Process Privilege

of the Freedom of Information and Privacy Act

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COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

May 16, 2019

The Honorable Tom Emmer
U.S. House of Representatives
Washington, DC 20515

Dear Representative Emmer:

Thank you for your letter dated April 11, 2019, requesting that we provide additional guidance for taxpayers regarding the tax consequences of virtual currency transactions.

As noted in your letter, we issued Notice 2014-21, which stated that virtual currency is treated as property and existing tax principles applicable to property transactions apply to virtual currency transactions. Since that time, virtual currency as a medium of exchange and investment has continued to develop. We have received numerous comments in response to the Notice and have been working with internal and external stakeholders to identify areas where needed and helpful additional guidance can be provided.

I share your belief that taxpayers deserve clarity on basic issues related to the taxation of virtual currency transactions and have made it a priority of the IRS to issue guidance. Specifically, your letter mentions (1) acceptable methods for calculating cost basis; (2) acceptable methods of cost basis assignment; and (3) tax treatment of forks. We have been considering these issues and intend to publish guidance addressing these and other issues soon.

I hope this information is helpful. I am sending a similar letter to your colleagues. If you have additional questions, please feel free to contact me, or a member of your staff may contact Leonard Oursler, Director, Legislative Affairs, at 202-317-6985.

Sincerely,

Charles P. Rettig

Congress of the United States
Washington, DC 20515

April 11, 2019

Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue N.W.
Washington, D.C. 20224

RECEIVED
By Executive Secretariat Correspondence Office at 9:42 am, Apr 17, 2019

Dear Commissioner Rettig,

We are writing to urge the Internal Revenue Service (IRS) to issue needed guidance on the tax consequences and basic reporting requirements for taxpayers that use virtual currencies. Taxpayers deserve clarity on several basic unanswered questions regarding federal taxation of these emerging exchanges of value.

It has been over a decade since the IRS National Taxpayer Advocate identified, in its 2008 Annual Report, that the ambiguous tax treatment of virtual property and currency transactions was one of "the most serious problems encountered by taxpayers," and nearly five years since your agency released preliminary guidance on the issue. Over two years ago, the Inspector General for Tax Administration found that 2014 guidance lacking and recommended that the IRS "should take action to provide updated guidance to reflect the documentation requirements and tax treatments needed for the various uses of virtual currencies." Your Service agreed.

While we acknowledge and appreciate the guidance your agency released in 2014, there is still substantial ambiguity on a number of important questions about the federal taxation of virtual currencies. In particular, we feel there is urgent need for guidance on the following issues:

1. Acceptable methods for calculating the cost basis of virtual currencies. Which specific methods does the IRS consider to constitute "a reasonable manner that is consistently applied," as required by Notice 2014-21?
2. Acceptable methods of cost basis assignment and lot relief for virtual currencies. Do taxpayers need to use specific identification whenever they spend or exchange virtual currency, or are other methods, such as first-in-first-out or average cost basis, acceptable as well?
3. The tax treatment of forks for taxpayers that use virtual currencies, such as the 2017 hard fork of the Bitcoin blockchain.

There are many other open questions about the federal taxation of virtual currencies, but we feel that there is particular urgency in resolving the ambiguity around basic questions of how taxpayers should calculate and track the basis of their virtual currency holdings. It is not reasonable to expect taxpayers to satisfactorily answer these complex questions while the IRS remains silent.

We urge the IRS to issue more robust guidance clarifying taxpayers' obligations when using virtual currencies. In addition, we respectfully request a written response to this letter describing the IRS's efforts to issue updated virtual currency guidance, including what topics will be covered and what timeline for release is anticipated. Please submit your written response to us by May 15, 2019.

We appreciate your prompt response to this request and look forward to working with you on these and other issues facing United States taxpayers.

Sincerely,

Tom Emmer
Member of Congress

Bill Foster
Member of Congress

David Schweikert
Member of Congress

Darren Soto
Member of Congress

Patrick McHenry
Member of Congress

James P. McGovern
Member of Congress

French Hill
Member of Congress

Terri Sewell
Member of Congress

Warren Davidson
Member of Congress

Stephen F. Lynch
Member of Congress

Ted Budd
Member of Congress

Eric Swalwell
Member of Congress

Trey Hollingsworth
Member of Congress

Ed Perlmutter
Member of Congress

Greg Gianforte
Member of Congress

Josh Gottheimer
Member of Congress

Mark Meadows
Member of Congress

Lance Gooden
Member of Congress

Matt Gaetz
Member of Congress

Ted S. Yoho, D.V.M.
Member of Congress

Bryan Steil
Member of Congress

Congress of the United States

U.S. House of Representatives

COMMITTEE ON WAYS AND MEANS

1102 LONGWORTH HOUSE OFFICE BUILDING
(202) 225-3625

Washington, DC 20515-6348

http://waysandmeans.house.gov

September 19, 2018

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Dear Acting Commissioner Kautter:

On May 17, 2017, we wrote to the IRS to raise questions about the enforcement actions being taken against those holding virtual currencies and the lack of a comprehensive virtual currency strategy. More than a year after our initial letter, the IRS continues to expand its enforcement activities without issuing any further guidance for taxpayers. We therefore write again today to strongly urge the IRS to issue updated guidance, providing additional clarity for taxpayers seeking to better understand and comply with their tax obligations when using virtual currencies.

Since the emergence of virtual currencies, the IRS has struggled with how to treat virtual currencies for tax purposes and the amount of guidance necessary to assist taxpayers in understanding their tax obligations. In March 2014, the IRS began working to clarify tax issues related to virtual currencies by issuing guidance indicating that virtual currencies would be treated as property for tax purposes.[1] However, in September 2016, the Treasury Inspector General for Tax Administration reported that the IRS had yet to develop a comprehensive virtual currency tax strategy, citing a need for the IRS to update its initial guidance to reflect the various uses of virtual currencies. The Association of International Certified Professional Accountants, the American Bar Association, and other organizations have all raised similar concerns, each noting the need for additional clarity through updated guidance. Furthermore, the IRS Commissioner, in his response to our May 2017 letter, described Notice 2014-21 as "preliminary guidance," leaving the Committee to conclude that the IRS intended to issue additional guidance. However, to date, the IRS has not issued any additional guidance that taxpayers may rely upon to better understand their tax obligations.

Despite the issuance of only preliminary guidance on this issue, the IRS has made enforcement of this guidance a priority, undertaking robust enforcement actions on a number of fronts. For example, the IRS has used its John Doe Summons authority to seek the records of approximately half a million Americans who held virtual currencies between 2013 and 2015. In addition, on

[1] IRS, *IRS Virtual Currency Guidance*, Notice 2014-21 (March 25, 2014).

July 2, 2018, the IRS's Large Business and International division announced five new compliance campaigns, one of which focuses on non-compliance related to virtual currencies. At the same time, the IRS also announced that it would not be providing leniency for taxpayers by allowing for a voluntary disclosure program to address tax non-compliance related to virtual currencies.[2]

The IRS has also sought to remind taxpayers of the penalties for non-compliance with its preliminary guidance. In March 2018, the IRS reminded taxpayers that those who do not properly report the income tax consequences of virtual currency transactions can be audited for those transactions and held liable for penalties and interest. In more extreme situations, taxpayers can be subject to criminal prosecution for failing to properly report the income tax consequences of virtual currency transactions.[3]

While the Committee appreciates the IRS's need to undertake enforcement actions to ensure that taxpayers generally meet their tax obligations, in this case, we are concerned that the IRS is seeking to enforce guidance that does not adequately advise taxpayers of their tax obligations when using virtual currencies. Furthermore, while the issues surrounding virtual currencies are complicated and ever evolving, a key component of the IRS's duties as the nation's tax administrator is to assist taxpayers in understanding what their tax obligations are and how they may best meet them. A failure to put forth adequate guidance severely hinders taxpayers' ability to do so. The IRS has had four years to work through these issues since its preliminary guidance was issued, providing more than adequate time for the IRS to thoughtfully consider what additional information is needed.

We therefore strongly urge the IRS to expeditiously issue more robust guidance clarifying taxpayers' obligations when using virtual currencies. We also ask that you provide a written response outlining where the IRS is in its efforts to issue updated virtual currency guidance, what the IRS intends to cover in this guidance, and a timeline for its release. In addition, to assist the Committee in better understanding this issue, we will be asking the Government Accountability Office to undertake an audit on this matter.

Thank you in advance for your prompt response to this request. We ask that you provide this information to the Committee no later than October 17, 2018. As always, we also ask that you answer the questions on a question by question basis, indicating which questions that you are answering. If you have any questions or concerns, please contact Lindsay Steward of the House Ways and Means Committee at (202) 225-9263.

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[2] *IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns*, https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns (July 2, 2018).

[3] Criminal convictions for possible charges such as failure to file or tax evasion can lead to prison terms of up to three years or five years, respectively and fines of up to $250,000.

Sincerely,

Kevin Brady
Chairman
Committee on Ways and Means

Lynn Jenkins, CPA
Chairman
Committee on Ways and Means
Subcommittee on Oversight

David Schweikert
Member of Congress

Darin LaHood
Member of Congress

Brad Wenstrup
Member of Congress

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

October 24, 2018

The Honorable Kevin Brady
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Brady:

Thank you for your letter dated September 19, 2018, regarding our efforts to provide additional guidance for taxpayers on the use of virtual currency.

We issued Notice 2014-21 to address how general tax principles apply to transactions using virtual currency. This notice provides that virtual currency is treated as property and tax principles that apply to property transactions apply to virtual currency transactions.

Since we published Notice 2014-21, we have continued working with external stakeholders to identify concerns and to actively study virtual currency issues. The Internal Revenue Service Advisory Council (IRSAC), a group of IRS officials and external stakeholders, has been working on how we can provide more clarity for taxpayers seeking to understand and comply with their tax obligations when using virtual currencies. Additionally, we have an interdisciplinary team that meets regularly on virtual currency issues We continue to study the issues to determine what additional guidance will be most helpful to taxpayers.

I hope this information is helpful. I am sending a similar letter to your colleagues. If you have any questions, please feel free to contact me, or a member of your staff may contact Leonard Oursler, Director, Legislative Affairs, at 202-317-6985.

Sincerely,

Charles P. Rettig

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

June 16, 2017

The Honorable Orrin G. Hatch
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Hatch:

Thank you for your letter dated May 17, 2017, about our digital (or virtual) currency strategy. I appreciate the opportunity to update you on our strategy. I also understand that my staff will brief your staff about the issues raised in your letter on June 19, 2017.

The use of virtual currency has grown in popularity in recent years. While there has been significant publicity around individuals using virtual currency to evade tax obligations and commit nontax crimes such as money laundering, we are mindful that many taxpayers also use virtual currency for bona fide purposes. To provide certainty to these taxpayers, the IRS and Treasury Department issued preliminary guidance in Notice 2014-21 and requested comments from the public.

We share your concern that financial technology companies and virtual currency users should not be subject to undue compliance burdens, and we will consider such burdens when implementing our virtual currency strategy. However, we also take very seriously our responsibility to administer and enforce the nation's tax laws. To that end, the IRS uses the tools that Congress provided in the Internal Revenue Code, such as the John Doe summons authorized by section 7609(f) and referenced in your letter, to further its investigation of compliance with the internal revenue laws. As your letter recognizes, in accordance with section 7609(f), court approval is required for the IRS to issue a John Doe summons.

Your letter asks a number of specific questions. I enclosed a response to each of your questions. As these responses show, we continue to develop an overall strategic approach to virtual currency. We would be happy to discuss with your staff how legislation could also bring some clarity to this area.

I hope this information is helpful. I am sending a similar letter to the other Chairmen who signed the inquiry. If you have additional questions, please contact me, or a member of your staff may call Leonard Oursler, Director, Legislative Affairs, at 202-317-6985.

Sincerely,

John A. Koskinen

Enclosures (3)

Congress of the United States
Washington, DC 20515

May 17, 2017

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Commissioner Koskinen:

In the United States Congress, the Senate Committee on Finance and the House Committee on Ways and Means have an exclusive jurisdiction over federal revenue measures. Under Senate and House rules, the Committees have corresponding authority to conduct oversight of activities within their jurisdiction. As such, the Committees have a responsibility to examine Internal Revenue Service (IRS) actions in emerging areas of tax administration, including digital currencies. We write today to request information about the IRS's digital currency strategy as well as recent events surrounding the IRS's summons to Coinbase, a digital asset exchange company.[1]

In March 2014, the IRS began working to clarify tax issues related to digital currencies by issuing guidance indicating that digital currencies would be treated as property for tax purposes.[2] However, in September of 2016, the Treasury Inspector General for Tax Administration (TIGTA) reported that the IRS had yet to develop a comprehensive digital currency tax strategy, citing a need for the IRS to update its initial guidance to reflect the various uses of digital currencies. To date, no such update has appeared.

Despite the absence of a comprehensive strategy, on December 6, 2016, the IRS issued a summons to Coinbase requiring the records of all American Coinbase customers who conducted transactions in convertible digital currency between January 1, 2013 and December 31, 2015. The summons is estimated to affect 500,000 active Coinbase customers and would result in the production of millions of pages of associated records, many of which contain personally-identifiable information. However, 90 percent of these customers engaged in less than $10,000 in cumulative, gross transactions during the entire period requested.

According to the Internal Revenue Code (IRC), the issuance of this type of summons -- called a John Doe Summons -- requires the government to establish that the summons pertains to an

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[1] Coinbase is an American company that serves as a digital currency wallet where merchants and consumers can transact new digital currencies such bitcoin and ethereum.
[2] IRS, *IRS Virtual Currency Guidance*, Notice 2014-21 (March 25, 2014).

ascertainable class of persons, whose identity is unknown, and with respect to whom the IRS has a "reasonable basis" for the belief that the individuals have failed to comply with tax laws.[3] However, we strongly question whether the IRS has actually established a reasonable basis to support the mass production of records for half of a million people, the vast majority of whom appear to not be conducting the volume of transactions needed to report them to the IRS. Based on the information before us, this summons seems overly broad, extremely burdensome, and highly intrusive to a large population of individuals. The IRS's actions in this case also set a dangerous precedent for companies facilitating virtual currency transactions that could be subject to a similar summons. To assist the Committees in better understanding the IRS's actions in this case, please provide the following information:

1. Please describe the IRS's current digital currency strategy and provide any existing policies and procedures.
    a. What efforts has the IRS made to conduct industry outreach or coordination on its digital currency strategy?
    b. What, if any, industry concerns have been raised and what actions is the IRS taking to address these?
    c. How does the John Doe summons issued to Coinbase fit into the larger IRS digital currency strategy?
2. As mentioned earlier, to issue a John Doe summons, the IRS must first establish that it has a reasonable basis to believe that the individuals may fail or may have failed to comply with internal revenue law. What is the justification for the IRS's position that *all* Coinbase customer records are needed for this timeframe?
    a. When seeking this summons, what provision(s) of the IRC did the IRS believe Coinbase customers not to be in compliance with?
    b. Did the IRS consider issuing a more narrowly tailored summons? If so, what impediments existed to the IRS issuing a more narrowly tailored summons?
3. TIGTA made three recommendations in its 2016 report referenced above. What is the current status of the IRS's implementation of each of these recommendations and what actions have been taken to address each one?
4. How has or will the IRS assess and take into account the compliance burdens on start-up financial technology companies as well as digital currency users (especially those engaging in light to moderate transactional use) when developing and refining its digital currency strategy?
5. Will the IRS consider a de minimis exemption or other action to remove practical obstacles to such moderate, transactional use of digital currencies?

In addition, we ask that you, at your earliest convenience, provide a briefing to the staff of both Committees on this topic. Thank you in advance for your prompt response to this request. We ask that you provide this information to the Committee no later than June 7, 2017. As always, we also ask that you answer the questions on a question by question basis, indicating which questions that you are answering.

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[3] 26 U.S. Code § 7609(f) – *Additional Requirement in the Case of a John Doe Summons.*

If you have any questions or concerns, please contact Christopher Armstrong of the Senate Finance Committee at (202) 224-4515 or Lindsay Steward of the House Ways and Means Committee at (202) 225-9263.

Sincerely,

Orrin G. Hatch
Chairman
Senate Committee on Finance

Kevin Brady
Chairman
House Committee on Ways and Means

Vern Buchanan
Chairman
House Committee on Ways and Means
Oversight Subcommittee