Cryptocurrencies

Tax Planning for the New Asset Class

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Introduction to Cryptocurrencies

Decentralized cryptocurrency is produced by the entire cryptocurrency system collectively, at a rate that is defined when the system is created and that is publicly known. In centralized banking and economic systems, such as the Federal Reserve System, corporate boards or governments control the supply of currency by printing units of fiat money or demanding additions to digital banking ledgers. In the case of decentralized cryptocurrency, companies or governments cannot produce new units and have not so far provided backing for other firms, banks or corporate entities that hold asset value measured in it.

678%

The cryptocurrency market has undergone explosive growth in 2017 (678%) from January through September, with asset managers beginning to view cryptocurrency as a new viable asset class that can be used to generate returns for investors and fund managers alike.

$180b

With a market cap at the end of October 2017 of approximately $180 billion, cryptocurrency is finding its way onto major exchanges and into the balance sheets of asset managers, high net worth individuals, family office groups, merchants, technology companies and many others.

2,152%

Taking a longer view, from 2013 to 2017, the Eurekahedge Crypto-Currency Fund Index had a cumulative return of 2,152%, which, on an annualized basis, comes to 125% for actively managed cryptocurrency strategies.

1000+

Bitcoin was the first cryptocurrency created with an intent to free currency from the ties of any jurisdiction so that people would be the driving force for how the currency would perform. Using the same base of the technology that supported bitcoin (i.e., blockchain, or a so-called distributed-ledger technology), developers were able to create Ethereum, Ripple and many other cryptocurrencies. Currently, there are more than 1,000 cryptocurrencies trading in the market. Many of these new cryptocurrency coins go beyond being used as currency, with elements of profit-sharing, access to services or other features dreamed up by the issuer. These cryptocurrencies are changing the way people do business and the way they invest in new companies.

Current US Jurisdictional Guidance on Cryptocurrency

Recently, we have seen a growth in asset managers employing complex strategies around a variety of cryptocurrencies that have been issued in the market. As asset managers begin to launch funds that are solely dedicated to this asset class, they will need to determine how traditional regulatory and tax rules apply.

In March 2014, the IRS issued its only formal guidance on what it called "virtual" currency. In IRS Notice 2014-21, it stated that virtual currency operates like "real" currency, as it is used as legal tender. It circulates and is customarily used and accepted as a medium of exchange, but it has no legal tender status in any jurisdiction. Therefore, for US federal income tax purposes, virtual currency is not a "currency" but a capital asset and should be treated as intangible personal property.

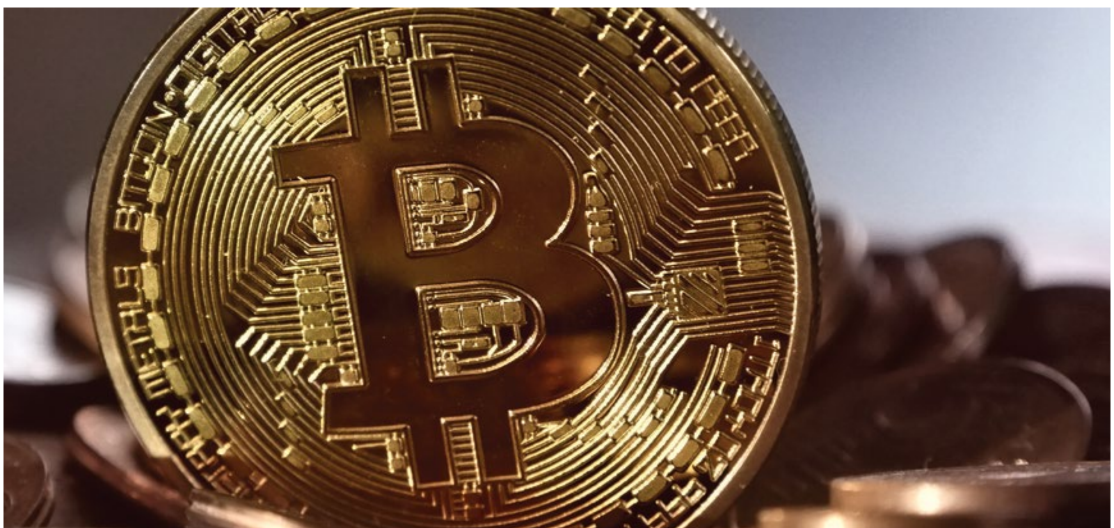
There are some additional consequences under IRS Notice 2014-21 that are also worth noting. The fair market value (FMV) of virtual currency must be taken into account when determining the proper amount of income to recognize. For instance, the use of virtual currency as a means of payment is treated as a sale to the payee at its respective FMV. As one could imagine, there are various reporting and/or withholding tax issues to assess.

Examples were provided in the notice, such as, if wages were paid to employees using virtual currency, such payments would be taxable to employees, reported by the employer on Form W-2 and subject to federal income tax withholding and payroll taxes. In addition, the notice stated that the character of gain/loss on the sale or exchange of virtual currency depends upon the intent of the taxpayer.

The SEC has also made its initial determination and analysis on cryptocurrency through a preliminary investigation on the "DAO token," an acronym for "decentralized autonomous organization." A DAO token is a virtual organization token embodied in computer code and executed on a distributed ledger/blockchain. The SEC analyzed whether these tokens issued would be an "investment contract" and, therefore, a security, under which the US Securities Act of 1933 and the US Securities Exchange Act of 1934 would apply. The SEC determined that a transaction is a security if there is an investment contract involving an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial effort of others. Accordingly, the SEC determined that the DAO token was a security requiring SEC oversight. However, the SEC also commented that each future token offering needs to be reviewed under its own facts and circumstances to determine whether that token will also be considered a security.

Finally, the Commodity Futures Trading Commissions (CFTC) has also been involved in the regulation of cryptocurrency. The CFTC first officially recognized bitcoin as a commodity in September 2015 when it went after CoinFlip for operating a platform for trading bitcoin options without the proper authorizations, thus asserting its jurisdiction over bitcoin and other cryptocurrencies. The CFTC is also pushing the coverage of existing investment options to bitcoin through the approval of companies like LedgerX as a swap execution facility, allowing for it to be the first federally regulated bitcoin options exchange and clearinghouse in the institutional market.

However, the IRS has not commented on the determination made by the SEC that the DAO token is a security or the CFTC position that Bitcoin is a commodity. In December of 2017, Bitcoin futures began to trade on regulated markets. This could support a position that Bitcoin (NOTE: not all cryptocurrencies) should be considered as a commodity.



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Tax Planning for Cryptocurrency

As asset managers become more interested in the investment opportunities surrounding cryptocurrency, this raises concerns within the financial industry regarding the tax treatment of this new asset class. Unless cryptocurrency is defined by the IRS as a security or a commodity, it will remain unclear as to the ultimate tax implication of owning such an asset and whether current industry-specific rules will apply.

The following discussion is based on the current IRS determination that a cryptocurrency is simply intangible personal property.

1 | The Cost Recovery Method of Your Cryptocurrency

Typically, in order to buy large quantities of cryptocurrency, it may take several purchases in several exchanges over a period of time. Since most cryptocurrency exchanges are not designed to track your cost and determine your gain or loss on any sale or exchange, this process will fall upon the investor. The investor will need to implement a cost recovery methodology that is reasonable under potential IRS examination. Since cryptocurrency is currently not defined as a security by the IRS, the default rule is traditionally specific identification. However, this could be burdensome with so many lots purchased over time. The investor will need to document if another method such as first-in, first-out; last-in, first-out or weighted average can be employed and will be an acceptable cost recovery method by the IRS.

2 | The Application of IRC Section 1091 (Wash Sales Rules)

The wash sales rules prohibit a taxpayer from claiming an Internal Revenue Code (IRC) Section 165 loss on the sale or exchange of a security when the taxpayer sells or trades a security at a loss and then buys a "substantially identical" security either 30 days before or after the original trade date of the loss. Since the current IRS position is that cryptocurrency is not clearly defined as a security, the wash sale rules should not apply without further guidance.

3 | The Application of IRC Section 864 (b) - the Safe Harbor Exemption

In general, absent an exception under an applicable income tax treaty, foreign investors engaged in trade or business in the US are taxable on a net basis on income connected with such trade or business. IRC Section 864(b) provides a safe harbor for investment entities if they are trading in stocks and securities or commodities in the US on their own account. Based on the current IRS position, and without further guidance, the safe harbor exception may not be available, and any foreign investors with exposure to cryptocurrency through an investment partnership could be subject to US federal taxation and reporting on all gains.

4 | The Application of IRC Section 1031 (Like-kind Exchanges)*

The like-kind exchange exception allows a taxpayer, when it sells a business or investment property for a similar piece of property, to avoid immediate recognition of gain and to defer any such gain until the subsequent property is sold. When the IRS first declared that cryptocurrencies would be taxed as a property, some theorized that if a taxpayer participated in a sale or exchange of cryptocurrency for another cryptocurrency, they could avail themselves of the like-kind exchange gain deferral mechanism. However, with more than 1,000 cryptocurrencies and more being added in the market, each new cryptocurrency has a unique underlying technology, whether it be blockchain or something else, which may make it different from another cryptocurrency. In addition, several coins or tokens have a variety of elements and features that may cause them to be considered different. If a taxpayer wishes to argue for referral of gain under IRC Section 1031*, then they must clearly define and describe why the two coins exchanged fit the category of being like-kind property.

This issue also impacts any investor wishing to be involved in a new initial coin offering (ICO), as many such transactions can only be done through owning other coins and not fiat currency. Without further guidance, any acquisition of a cryptocurrency through an ICO could be a taxable event.

> ***Note: As this article was prepared, the Tax Cuts and Jobs Act limited the ability to apply IRC Section 1031 solely to real property. Therefore, the potential application of IRC Section 1031 to cryptocurrency is only viable for tax year 2017 and earlier years.**

5 | The Application of Being an Investor or Trader and Making an IRC Section 475 (f) Election

If a fund's trading activity rises to the level of a trader, this allows the fund to treat the activity as a trade or business, which allows expenses to be governed by IRC Section 162 (trader expenses, which are above-the-line expenses). Otherwise, any expenses incurred by the fund will be governed by IRC Section 212 (investment expenses). In brief, traders seek profit from daily market movements in prices of securities and commodities and not from capital appreciation over time. To be considered a trader, the activity must be substantial, continuous and with regularity. Currently, there is no definition in the code or regulations of what constitutes a trader, and nearly all of the guidance in this area comes from case law related to buyers and sellers of stocks and securities. Assuming a cryptocurrency investor has a sufficient number of trades to qualify as a trader, further analysis may be needed to determine if any expenses can be classified under IRC Section 162.

In addition, the IRC Section 475(f) mark to market election allows only traders of securities and/or commodities to elect to recognize ordinary gain or loss as if sold at the end of the year for their fair market value. Once this election is made, it will apply to the current taxable year and any subsequent year unless revoked. Since cryptocurrency may not be a security or a commodity given the current guidance from Notice 2014-21, a fund's ability to make an IRC Section 475(f) election is an area that will need further assessment if trading cryptocurrency will be a material part of a fund's portfolio activity.

6 | Contributions and Distributions of Property Into and From a Partnership

Under IRC Section 721, there is a general nonrecognition rule of gain realized upon a contribution of property to a partnership "investment company," where the contribution does not result in the diversification of the transferor's assets. In addition, IRC Section 731 also has a nonrecognition rule when assets are distributed to the partner upon liquidation of their interest if the partnership is an "investment partnership" – defined as a partnership never engaged in a trade or business – and where substantially all of the assets have always consisted of cash, securities and derivatives. If the partnership intends to either receive contributions from, or distribute cryptocurrency to, a partner, it will need to make sure the nonrecognition principles under IRC Section 721 and IRC Section 731 apply.

7 | Publicly Traded Partnership Status

A partnership can be considered a publicly traded partnership (PTP) if the partnership interest is readily tradable on an established or secondary market. Accordingly, under IRC Section 7704(a), a PTP is generally taxed as a corporation (i.e., at the entity level). Commonly, to avoid PTP status, an open-ended partnership that allows partners to periodically exit and enter the partnership can be exempt if 90% or more of the partnership's gross income is "qualifying income." Without further guidance, if income from cryptocurrency is not considered qualifying income, a partnership may not be able to avail itself of this common exemption.

8 | Potential Future Legislation

Congress has considered enacting legislation governing the taxation of cryptocurrencies. In September 2017, Jared Polis, a Democrat from Colorado, and David Schweikert, a Republican from Arizona, introduced in the US House of Representatives a bill titled the Cryptocurrency Tax Fairness Act. This bill would create an exemption for transactions under $600. Those transactions would be considered nontaxable events, allowing the freedom to use coins for smaller sales transactions without being required to recognize gain or loss. In addition, it would require the Treasury Department to issue information reporting regulations governing cryptocurrency capital gain transactions.

Key Personnel

Muhammad A. Akram, *Founder and CPA*

Muhammad Akram is a Certified Public Accountant in the state of California (License #114908), New York (License #122344), and North Carolina (Certificate #37968) and leads the Firm's overall practice.

Muhammad earned a Bachelor of Accounting from SKANS School of Accountancy. He is a member of the American Institute of Certified Public Accountants (AICPA) and North Carolina Society of Certified Public Accountants.

He has worked with Ernst & Young International, Anchin Block and Anchin LLP, and Rothstein Kass & Co. where he worked on the audit, tax and consulting engagements for onshore and offshore alternative investment funds.

Muhammad has worked with hedge fund and mutual fund administrators and has supervised all aspects of fund accounting and financial reporting assignments. He has also been responsible for advising investment companies on structuring and compliance processes, and for providing consultation on regulatory and tax matters.

Ghias Khan, *CPA* and *Commercial Practice Leader*

Ghias is a Certified Public Accountant in the state of New York (License # 077913) and leads the Firm's commercial practice.

Ghias earned a Bachelor of Science with a major in Accounting from the State University of New York. He is a member of the American Institute of Certified Public Accountants (AICPA).

He has worked with regional and local CPA Firms on audit, review, compilation, tax and consulting engagements for non-public companies in various sectors of manufacturing, apparel, real estate, law firms, retail and wholesale, in addition to employee benefit plans.

Ghias is also integrally involved with developing enhancements and processes to service client requirements and procedures for operational efficiencies. He is responsible for quality control functions in our Firm and reviews every audit job subject to peer review.

Headquartered in North Carolina With a National Presence

Akram & Associates PLLC is a full-service PCOB registered CPA Firm. We are licensed in five states including North Carolina (Reg #33032), New York (ID #110272), Oregon (2709), California (OFR 289), and Georgia (ACF006555).

Recognition

We are proud to serve as a trusted partner to our clients and are humbled by the industry recognition we have received. Akram has been shortlisted for both the HFM US Services Awards and Hedgeweek Americas Awards in 2019, 2020, and 2021 .

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