TAX ASPECTS OF CRYPTOCURRENCY

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"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 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 non-convertible cryptocurrencies, if at all.

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 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 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.

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 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

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" 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.

Notes

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/#54321cc075be; https://coinmarketcap.com/all/views/all/.

8 https://www.fincen.gov/news/news-releases/fincen-issues-guidance-virtual-currencies-and-regulatory-responsibilities; see also https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering.

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/FBAR%20Line%20Item%20Filing%20Instructions.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/#57cccec02bb3.

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/#13de44cb26a8.

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/.