AICPA

April 14, 2023

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Mr. William M. Paul
Principal Deputy Chief Counsel
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Re: Guidance Needed on the Tax Treatment of Losses of Digital Assets

Dear Commissioner Werfel and Principal Deputy Chief Counsel Paul:

The American Institute of CPAs (AICPA) is providing comments on needed guidance on the tax treatment of losses of digital assets. The Treasury Department ("Treasury") and Internal Revenue Service (IRS or "the Service") should consider the below comments in developing guidance to assist taxpayers in properly calculating their losses on digital assets.

We offer these comments, in addition to previously submitted comments,[1] with the hope that IRS will provide additional guidance to clarify how digital asset losses are handled in various scenarios. Such guidance will provide greater certainty to taxpayers and their preparers in confidently and properly complying with their overall reporting requirements for digital assets, and better ensure consistent application of the tax law among taxpayers.

Our comments and recommendations cover the following issues:

1. What facts indicate worthlessness of a digital asset?

2. What facts indicate abandonment of a digital asset?

3. When, if ever, might digital assets be securities for tax purposes?

4. Theft of a digital asset held for investment. Does the Ponzi loss guidance of Rev. Rul. 2009-9 and Rev. Proc. 2009-20 apply beyond Ponzi-losses to other fraudulent arrangements, including digital asset losses from certain digital asset exchange activities?

5. What is the tax effect of lending digital assets? (Some people may find themselves in this position with some bankrupt exchanges.)

[1] The AICPA has previously provided comments on virtual currency taxation matters including: "Comments on Notice 2014-21: Virtual Currency Guidance," June 10, 2016; "Updated Comments on Notice 2014-21: Virtual Currency Guidance," May 30, 2018; "Comments on Revenue Ruling 2019-24, the New Question on Schedule 1 (Form 1040), and the Internal Revenue Service's Frequently Asked Questions on Virtual Currency Transactions," February 28, 2020; "Comments on Virtual Currency Question on the Form 1040 and Instructions," August 29, 2022; "Comments on Virtual Currency Reporting under Internal Revenue Code Section 6045 and Section 6050I, and the Form 8300 and Instructions," October 28, 2022; and "IRS Draft Instructions to 2022 Form 1040 Pertaining to Digital Assets," December 16, 2022; and "AICPA Proposed IRS Frequently Asked Questions (FAQs) Pertaining to the 2022 Form 1040 Digital Asset Question," February 17, 2023.

6. When would section[2] 1234A apply to termination of a digital asset?

7. How should a taxpayer report digital asset activity if they are unable to access their records due to bankruptcy of an exchange?

8. Is a digital asset considered disposed of by transferring the investor's interest in a bankruptcy proceeding? Must there be proof of transfer of the underlying digital asset?

BACKGROUND

Current Law and Tax Issues Regarding Digital Assets and Losses

The Infrastructure Investment and Jobs Act (P.L. 117-58), 11/15/21) added a broker reporting requirement for digital assets. Section 6045(g)(3)(D) defines digital asset as follows:

> Except as otherwise provided by the Secretary, the term "digital asset" means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

The instructions to the 2022 Form 1040, U.S. Individual Income Tax Return, include the following explanation for the digital asset question on page 1 of Form 1040:

> Digital assets are any digital representations of value that are recorded on a cryptographically secured distributed ledger or any similar technology. For example, digital assets include nonfungible tokens (NFTs) and virtual currencies, such as cryptocurrencies and stablecoins. If a particular asset has the characteristics of a digital asset, it will be treated as a digital asset for federal income tax purposes.

IR-2023-12 (1/24/23) explains that common digital assets include:

- Convertible virtual currency and cryptocurrency
- Stablecoins
- Non-fungible tokens (NFTs)

Despite the creation of bitcoin in 2009, digital assets are still a nascent phenomenon and new types of assets and transactions emerge regularly. Consequently, taxpayers have a growing list of tax issues regarding many types of digital asset transactions that are not always addressed by Notice 2014-21, which provides that virtual currency is treated as property for tax purposes.

[2] Unless otherwise indicated, references to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), and references to a "Treas. Reg. §" are to the Treasury regulations promulgated under the Code.

We appreciate that it is challenging for the IRS to issue complete and timely guidance in the digital asset area. Given recent bankruptcies of some virtual currency exchanges and litigation brought by the SEC and other government agencies, one area currently affecting many individual investors involves losses. While existing guidance in the Code, regulations, revenue rulings and court opinions, is helpful, sometimes the unique nature of digital assets and transactions involving digital assets do not clearly fit within the existing guidance, thus leaving taxpayers and practitioners with uncertainty for reporting purposes. For example, Treas. Reg. § 1.165-1(d) on the year for which a loss may be claimed includes that for a casualty or other event, it cannot be claimed if there is a "reasonable prospect of recovery." While court cases[3] have explored this term for stock losses, there are no rulings indicating any actions individual investors are expected to take for digital asset losses to know if there is any "reasonable prospect of recovery."

Chief Counsel Advice (CCA) 202302011 (Jan. 13, 2023) discusses an example where Taxpayer A is an individual who purchased units of Cryptocurrency B in 2022 at $1.00 per unit for personal investment purposes on a cryptocurrency exchange. After Taxpayer A acquired Cryptocurrency B, the per unit value of Cryptocurrency B decreased significantly, such that Cryptocurrency B was valued at less than one cent per unit at the end of 2022.

The conclusion in this CCA is that the taxpayer has no loss from the decline in value since the taxpayer still holds the asset. In addition, it is not worthless despite a value under one cent as it still has value and is listed on at least one exchange. Neither is the cryptocurrency abandoned as the investor still holds it. This CCA does not address theft of digital assets, loss from lending digital assets, possible application of section 1234A, or gains or losses from certain terminations. In addition, a CCA is not binding guidance for either the IRS or taxpayers,[4] which leaves some uncertainty on whether the conclusions reached in it will match conclusions reached by IRS examiners.

Further guidance is needed for taxpayers to correctly calculate and report their losses on transactions involving digital assets. In this letter, we offer questions we think are most in need of guidance and offer suggestions for answering some of these questions.

GENERAL COMMENTS

Notice 2014-21 provides that virtual currency is treated as property and that general principles applicable to property transactions will apply to virtual currency. Sale, exchange, or other disposition of virtual currency may result in gain or loss and the characterization of such gain or loss generally depends on characterization under section 1221, capital asset defined. If the taxpayer is not in the trade or business of dealing with cryptocurrency (is not a dealer under section 1221(a)(1)), gain or loss resulting from sale or exchange will be characterized as capital gain or loss (section 1222). The loss discussion and recommendations in this letter focus on digital assets held by an investor rather than by a trade or business.

[3] For example, see *Adkins*, 960 F.3d 1352 (Fed. Cir. 2020).
[4] CCAs are not published in the Internal Revenue Bulletin so are not binding on the IRS (Treas. Reg. § 601.601(d)) and are not listed as "authority" under Treas. Reg. § 1.16662-4(d)(3)(iii).

If a taxpayer sustained a loss that is not from a sale or exchange, the taxpayer needs to determine whether the loss is sustained because of worthlessness or other event, such as theft, as well as whether a special rule, such as under section 165(g) or section 1234A, applies to determine the character of the loss. In addition, sections 62, 63 and 67 allow individuals to reduce taxable income for losses from sale or exchange or property, business losses, and casualty or theft losses described at section 165(c)(2) or (3). Through 2025, an ordinary loss from a non-security asset of an investor is not allowed. Varied rules and tax results make it important for individual investors to understand the nature of their digital asset loss and its treatment under the tax law.

In addition, special definition and rules apply to theft losses. Guidance in this area has not involved digital assets due to the newness of these assets. Guidance is needed, including whether the special safe harbor rule for "Ponzi schemes" laid out in Revenue Procedure 2009-20 might apply to any digital asset losses.

SPECIFIC COMMENTS

1. What facts indicate worthlessness of a digital asset?

Overview

Section 165(a) allows a deduction for losses sustained during the tax year not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) adds that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and Treas. Reg. § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

CCA 202302011 states that "a loss may be sustained…if a cryptocurrency becomes worthless resulting in an identifiable event that occurs during the tax year for purposes of section 165(a)." *Boehm v. Commissioner*[5] is cited providing that worthlessness of an asset is a question of fact, and *Echols v. Commissioner*[6] explains that worthlessness can occur with respect to assets not relinquished but proven essentially valueless. *Morton v. Commissioner*[7] provides that worthlessness for a loss deduction depends on both current liquidating value and any potential future value being zero.

In what instances will a cryptocurrency be deemed valueless? CCA 202302011 states that a section 165(a) loss deduction does not arise even where the cryptocurrency value is less than one cent (still has value greater than zero), and because it continued to be traded on at least one exchange that could potentially create future value.

[5] 326 U.S. 287, 293 (1945).
[6] 935 F.2d 703, 708 (5th Cir. 1991).
[7] 38 B.T.A. 1270, 1278 (1945).

A trait of many types of virtual currency is that it can be represented in fractionalized units with values less than a penny and might even have 18 or more decimal places. For example, some people are paid a small fraction of a bitcoin for microtasks or for transfer of low value cryptocurrency, such as receiving a few "sats." A sat or Satoshi represents 1/100,000,000 of a bitcoin, which is likely to be a small fraction of one cent. Thus, it appears so long as the asset continues to have current or future potential value greater than absolute zero, a worthless deduction is not allowed. The potentially small units allowed for many types of cryptocurrencies supports treating values below one cent as true value, rather than being worthless.

In addition, we note that a taxpayer may not have access to any exchanges to trade a particular digital asset due to regulatory prohibitions or the termination of the exchange or that it is not traded on any exchange (given the decentralized nature of most cryptocurrencies, trading on an exchange is not required). The one exchange example in CCA 202302011 assumes the taxpayer can use that exchange, so that the token has value. Suggested modifications to the CCA example include that while it might be listed on some exchange, the investor might not have access to it (such as due to regulatory restrictions), or it might not be listed on any exchange, but it can still be transferred to an unrelated third party either on-chain or off-chain.

Despite finding that the asset in CCA 202302011 is not worthless, the CCA includes the reminder that under section 67(g)(2), the ordinary loss that does not arise from casualty, theft, or wagering (and is not a capital loss) is a miscellaneous itemized deduction and not allowed for 2018 through 2025.[8] Clearly, this is an unfavorable tax result (no tax benefit of the investment loss) and investors will want to avoid having a worthless digital asset (such as selling it before it becomes worthless). Thus, knowing what the IRS views as indicators of worthlessness will be very helpful to taxpayers.

Recommendations

If the position of Treasury and IRS is that as a cryptocurrency is listed on an exchange and has liquidating value greater than absolute zero, we recommend Treasury and IRS state this in binding guidance (published in the Internal Revenue Bulletin).

In addition, we recommend that such guidance address modifications to the CCA fact pattern including where the digital asset is not listed on any exchange, but it can still be transferred by the investor on-chain (on the distributed ledger) or off-chain (transfer of the access codes to another person). Binding guidance should also address the tax effect if the digital asset cannot be transferred, such as because the distributed ledger is no longer functional or the sponsor of the asset has terminated it. For example, if there is no way to access or transfer the cryptocurrency on the distributed ledger, is the asset considered worthless for a section 165(a) deduction? Additionally, not all cryptocurrency is traded on an exchange – what are the key indicators of an asset having value in these cases? All indicators of worthlessness relevant to the traits of digital assets would be helpful to taxpayers.

[8] Section 67 applies because the ordinary loss from a worthless investment of an individual that is from a non-security capital loss is not allowed for AGI (section 62) and it only allowed from AGI (section 63) as a miscellaneous itemized deduction subject to the two-percent of AGI limitation.

Finally, in CCA 202302011, the IRS determined that the cryptocurrency in the example was not a security for the purposes of a section 165(g) worthless stock loss treatment. Is the Service applying this statement broadly to all cryptocurrency or is it being applied to the specific cryptocurrency mentioned? We recommend the IRS identify situations where a cryptocurrency is a security for purposes of section 165(g). See next section for more on this issue.

2. **What facts indicate abandonment of a digital asset?**

Overview

Section 165(a) provides a deduction for losses sustained during the tax year not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) adds that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and Treas. Reg. § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form govern in determining a deductible loss.

Treas. Reg. § 1.165-2(a) discusses the obsolescence of nondepreciable property held for business or investment, providing that where a business or transaction is discontinued or where such property is permanently discarded from use, there shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained.

With respect to when a loss has been sustained from abandonment of an asset, the IRS references *Franklin v. Commissioner*[9] in CCA 202302011, which states a loss under Reg. § 1.165-2(a) occurs if: "(1) the loss is incurred in a business or a transaction entered for profit; (2) the loss arises from the sudden termination of usefulness in the business or transaction; and (3) the property is permanently discarded from use, or the transaction is discontinued."

Another case referenced in the CCA, *Massey-Ferguson, Inc. v. Commissioner,*[10] explains that abandonment is proven through an evaluation of the surrounding facts and circumstances, which must show both intent and affirmative action to abandon the property. The mere intention to abandon property or non-use alone is not enough,[11] and "some express manifestation of abandonment is required when the asset is an intangible property interest."[12]

CCA 202302011 explains that because the taxpayer had maintained ownership of their cryptocurrency, continuing to exert dominion and control over it, with no affirmative steps to abandon the property, no section 165(a) loss deduction would be allowed despite any abandonment intent.

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[9] T.C. Memo 2020-127.
[10] 59 T.C. 220 (1972).
[11] *Beus v. Commissioner*, 261 F.2d 176, 180 (9th Cir. 1958), aff'g 28 T.C. 1133 (1957).
[12] *Citron v. Commissioner*, 97 T.C. 200, 209–10, 213 (1991).

The CCA does not address what events and actions would indicate abandonment of a digital asset, instead referring to law that did not involve a digital asset. Given that the tax result of an abandoned digital asset is not favorable (it is the same result as for worthless digital assets held for investment — not allowed for 2018 through 2025), investors will want to avoid doing something that the IRS would view as abandoning their digital asset. Thus, knowing what the IRS views as indicators of abandonment of a digital asset will be very helpful to taxpayers.

Recommendations

Treasury and the IRS should explain what would be considered intent and affirmative steps in abandoning a digital asset. For example, would sending cryptocurrency to a burn or null account from which no trading can continue constitute abandonment? Is destruction of the private keys needed to access a digital asset constitute abandonment? If yes, what proof must the investor have? What if a distributed ledger or blockchain exists for the digital asset but no miners or nodes are in operation?

CCA 202302011 provides some indicators of when a cryptocurrency will be considered abandoned, citing several relevant court cases, however, it cannot be used or cited as precedent (and might not be providing all indicators of abandonment, particularly since the cases cited did not involve digital assets). We recommend that guidance on the tax treatment of abandoned digital assets and the indicator of abandonment be issued in a form that can be relied upon by all taxpayers and the IRS (that is, in guidance published in the Internal Revenue Bulletin).

3. When, if ever, might digital assets be securities for tax purposes?

Overview

Section 165(g) provides that "if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall … be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset." In CCA 202302011 the IRS provides that Cryptocurrency B is not a security, so section 165(g) does not apply to generate a capital loss (if B were worthless). The CCA reaches this conclusion by stating that Cryptocurrency B is none of the items listed in section 165(g)(2) on "security defined." There is no explanation of when a cryptocurrency or other type of digital asset would be treated as a security.

The Securities and Exchange Commission (SEC) has brought actions against some individuals and organizations and issues rulings finding that some digital assets are securities under securities laws. It is not clear if any of these findings apply for tax purposes, such under section 165(g).

Limited tax guidance has raised questions on whether or when any digital asset might possibly be a security for tax purposes. For example, consider the following:

- Section 6045(g) as amended in November 2021 by the Infrastructure Investment and Jobs Act list "digital assets" as a "covered security" under section 6045(g)(3)(B)(iv) for broker reporting purposes.
- Notice 2014-21 states that "virtual currency" should be treated as property for federal tax purposes. The notice provides an example in Q-7 that compares the type of gain or loss a taxpayer will realize on the sale or exchange of virtual currency to "stocks, bonds, and other investment property."
- IRS Virtual Currency FAQ-39 states that taxpayers can use a "deemed" specific identification method for determining basis in virtual currency that is disposed of. FAQ-41 states that the First In First Out (FIFO) method of accounting is the suggested method of accounting for determining basis in sold virtual currency if the specific identification method is not used. Treas. Reg. § 1.1012-1(c)(1) requires FIFO treatment to determine basis when stock is sold, except for when there is an average basis method in place, or the taxpayer properly uses the specific identification method as provided in the regulation for stock sales. Allowance of the use of FIFO for virtual currency is unusual because for investment property, the tax law only allows that for stock sales.
- CCA 202302012 (Jan. 13, 2023) states that a qualified appraisal is required for cryptocurrency donations in excess of $5,000 and the "readily valued property" exception applicable to securities at section 170(f)(11)(A)(ii)(I) does not apply.
- CCA 202302011 states that the worthless security loss rule at section 165(g) does not apply to cryptocurrency because Cryptocurrency B is "none of the items listed in section 165(g)(2)."

Recommendations

Authoritative guidance is needed on when, if ever, the section 165(g) worthless security capital loss treatment applies to cryptocurrency and other digital assets. Binding guidance should also be provided on basis determination for digital assets (currently the special options are only in non-binding FAQs), as this is a matter relevant to measuring gains and losses.

4. Theft of a digital asset held for investment. Does the Ponzi loss guidance of Rev. Rul. 2009-9 and Rev. Proc. 2009-20 apply beyond Ponzi-losses to other fraudulent arrangements, including digital asset losses from certain digital asset exchange activities?

Overview

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.[13] To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions and fixed by identifiable events.[14]

[13] See also Treas. Reg. § 1.165-1(a). But see limitations on section 165 loss deductions by individuals in section 165(c)(3) and (h).
[14] Treas. Reg. § 1.165-1(b).

Section 165(a) generally allows a taxpayer to deduct losses from the theft of property if the taxpayer establishes (1) that a theft occurred under the law of the jurisdiction where the alleged loss occurred, (2) the amount of the theft loss, and (3) the date that the loss from the theft was discovered.[15] In the case of individual taxpayers, the theft loss deduction is limited to losses incurred in a trade or business or in any transaction entered into for profit, though not connected with a trade or business;[16] other theft losses sustained by individuals are personal casualty losses subject to the limitations of section 165(h)(3).

Section 165(e) provides that, for purposes of section 165(a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.[17] However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.[18] Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances.

The IRS has issued two contemporaneous pieces of guidance that address fraudulent "Ponzi" schemes such as the Stanford International Bank and Bernard Madoff frauds.

First, Rev. Rul. 2009-9 addresses the tax treatment of losses from criminally fraudulent investment arrangements that take the form of "Ponzi" schemes.[19] Among other holdings, Rev. Rul. 2009-9 holds that (i) a loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, under section 165, and (ii) a theft loss in a transaction entered into for profit is deductible under section 165(c)(2), not section 165(c)(3), as an itemized deduction that is not subject to the personal loss limits in section 165(h), or the limits on itemized deductions in sections 67 and 68.

Second, Rev. Proc. 2009-20 "provides an optional safe harbor method for eligible taxpayers to deduct theft losses from criminally fraudulent investment arrangements that take the form of "Ponzi" schemes."[20] This revenue procedure, which is narrowly focused upon the "qualified losses" of "qualified investors" in a "specified fraudulent arrangement," allows taxpayers within its scope to elect a safe harbor method for determining the amounts and taxable years in which the loss will be taken into account as a theft loss.[21] A taxpayer that is eligible to use the safe harbor

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[15] *Yoakum v. Commissioner,* T.C. Memo. 2004-191; *Monteleone v. Commissioner,* 34 T.C. 688, 692 (1960); *Zmuda v. Commissioner,* 79 T.C. 714, 728–729 (1982), affd. 731 F.2d 1417 (9th Cir.1984); *McKinley v. Commissioner,* 34 T.C. 59, 63–64 (1960).
[16] Section 165(c)(1) and (c)(2).
[17] Treas. Reg. § 1.165-8(a)(2).
[18] Treas. Reg. §§ 1.165-1(d), 1.165-8(a)(2).
[19] Rev. Rul. 2009-9, 2009-14 I.R.B. 735.
[20] Rev. Proc. 2009-20, 2009-14 I.R.B. 749, modified by Rev. Proc. 2011-58, 2011-50 I.R.B. 849 (addresses death of a 'lead figure' in a Ponzi scheme).
[21] Rev. Proc. 2009-20, § 7.

provisions of Rev. Proc. 2009-20 but chooses not to do so "is subject to all of the generally applicable provisions governing the deductibility of losses under section 165."[22]

a. Scope of Rev. Rul. 2009-9

Revenue Ruling 2009-9 contains several indications that suggest that the ruling was intended to apply narrowly to Ponzi schemes, which are a specific type of investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors.[23] The initial paragraph of Rev. Rul. 2009-9 states that the ruling "addresses the tax treatment of losses from criminally fraudulent investment arrangements that take the form of a 'Ponzi' schemes." The FACTS section describes a fact pattern that is expressly identified as a Ponzi scheme and is also labeled as "fraudulent investment arrangement." Finally, Rev. Rul. 2009-9 was issued contemporaneously with Rev. Proc. 2009-20, which contains safe harbor provisions for Ponzi scheme losses and references Rev. Proc. 2009-9 several times.

On the other hand, Rev. Rul. 2009-9 also contains indications that suggest the ruling is *not* limited to Ponzi schemes. The ruling frequently uses the term "fraudulent investment arrangement," which is not expressly defined[24] but appears to refer to both Ponzi and non-Ponzi frauds. For example, in the language of the first paragraph quoted above, the reference to "fraudulent investment arrangements that take the form of 'Ponzi' schemes" implies that there are fraudulent investment arrangements that do not take the form of Ponzi schemes. Similarly, the fact pattern is described as "a fraudulent investment arrangement known as a 'Ponzi' scheme."

Further, the issues of Rev. Rul. 2009-9 are framed, analyzed and concluded in general terms that are not expressly limited to Ponzi schemes. For example, Holdings One and Six conclude respectively that "[a] loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, under section 165" and "[a] theft loss in a transaction entered into for profit does not qualify for the computation of tax provided by section 1341." Significantly, the conclusions are not tied or restricted to the Ponzi fact pattern.

In some respects, the holdings of Rev. Rul. 2009-9 are simply restatements of general tax law principles that would apply to any fraudulent arrangement, whether Ponzi or non-Ponzi, or more generally to any theft loss. In other respects, the holdings of Rev. Rul. 2009-9 depart from generally applicable tax law treatment of theft losses, and the question whether the ruling is limited to Ponzi losses or applies to all fraud losses is far more significant. For example, under Holding 4, *Amount of deduction*, a taxpayer involved with a fraudulent investment arrangement has a single loss, even

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[22] Rev. Proc. 2009-20, § 8.

[23] *Cunningham v. Brown*, 265 U.S. 1 (1924); *In re Bernard L. Madoff Inv. Sec. LLC*, 12 F.4th 171 (2d Cir. 2021), cert. denied sub nom. *Citibank, N.A. v. Picard*, 212 L. Ed. 2d 217, 142 S. Ct. 1209 (2022).

[24] While "specified fraudulent arrangement" is not defined in Rev. Rul. 2009-9, it is defined in Rev. Proc. 2009-20 as "an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors' cash or property. For example, the fraudulent investment arrangement described in Rev. Rul. 2009-9 is a specified fraudulent arrangement."

where the involvement extends over multiple taxable years; the amount of such loss is computed as the net aggregate amount of all transactions with the arrangement.[25] This method of computing loss can produce results substantially different from a computation applying general theft loss principles on the basis of each taxable year.

As a further example, Holding 1, *Theft loss*, states that a loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, under section 165. This appears to be a broad holding that would relieve taxpayers from the uncertainties of determining whether fraud or embezzlement losses are attributable to theft, such as whether the element of criminal intent is satisfied where the taxpayer and the party charged with theft are not in privity because of an intervening entity, such as a brokerage or exchange.[26] Whether such relief is available to non-Ponzi fraud losses remains unclear.

b. Applicability of Rev. Proc. 2009-20 safe harbor to widely sustained fraud losses

A prompt and certain determination whether a fraud loss qualifies as a Ponzi loss for purposes of the safe harbor revenue procedures of Rev. Proc. 2009-20 is essential to the proper tax reporting of the loss. Taxpayers who qualify for the safe harbor procedures and desire to use them are required to take appropriate action on their tax return for the year of discovery as defined in Rev. Proc. 2009-20. Taxpayers who do not qualify or desire to use the safe harbor procedures must take appropriate action under the general theft loss rules of section 165 beginning with the applicable discovery year, which may be different than the discovery rule under the safe harbor provisions.

Despite its importance, the determination of whether a fraud loss qualifies as a Ponzi loss confronts taxpayers with significant difficulties and pitfalls. Taxpayers may be misled by a mistaken belief that "Ponzi scheme" encompasses any arrangement involving proven or suspected fraud or reckless business practices. They may rely upon inaccurate or premature statements in news reports, blogs or websites, which commonly misuse the term. The definitions of "specified financial arrangement," "qualified loss," and "discovery year" have numerous factual elements that depend upon sometimes uncertain and evolving information sources. Finally, a given individual or entity may be operating a Ponzi scheme with respect to certain individuals, accounts or assets but be operating a non-Ponzi fraud, or even a non-fraudulent activity with respect to others.

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[25] This treatment is broadly similar to the safe harbor treatment in Rev. Proc. 2009-20 (section 6).
[26] Distinction between direct and indirect fraud is discussed in CCA 200451030 (Dec. 17, 2004); CCA 200811016 (June 22, 2007) (discussing *Commissioner v. Vietzke*, 37 T.C. 504 (1961), acq. 1962-1 C.B. 4; Rev. Rul. 77-215, 1977-1 C.B. 51; Rev. Rul. 71-381, 1971-2 C.B. 126); *Perrotto v. C.I.R.*, T.C. Memo. 1977-99 (1977); *Sandquist v. C.I.R.*, T.C. Memo. 1978-281 (1978).

Recommendations

a. Clarify scope of Rev. Rul. 2009-9

We recommend that the scope of Rev. Rul. 2009-9 be clarified. In particular, the applicability of Holdings 1, 2, 3 and 4 to non-Ponzi fraud losses poses particular uncertainties to taxpayers with such losses.

b. Clarify applicability of Rev. Proc. 2009-20 safe harbor to widely sustained fraud losses

We recommend that Treasury and IRS consider issuing informal guidance regarding the extent to which large investment arrangements that have been determined to be wholly or partially fraudulent have also qualified as a specified financial arrangement for purposes of Rev. Proc. 2009-20. Such guidance would promote accurate reporting and minimize administrative burdens for both the IRS and taxpayers alike.

Additionally, we recommend that Treasury and IRS consider revising and reissuing the safe harbor procedures in Rev. Proc. 2009-20 to include both Ponzi and non-Ponzi fraudulent investment arrangements. While differing in certain respects, Ponzi and non-Ponzi fraud share significant common features that make a more comprehensive safe harbor scheme both feasible and desirable.

5. Tax effect of lending digital assets

Overview

Lending of cryptocurrency may have many different formats or aspects depending on the structure of the transactions. A common scenario is where a holder of a specific kind of cryptocurrency enters into agreement with another taxpayer or organization for "lending" of his cryptocurrency as a liquidity to that other taxpayer or organization. A taxpayer who lends out the cryptocurrency receives a set amount of additional cryptocurrency as a reward until the originally loaned cryptocurrency amount is returned. This sounds similar to lending money with a note evidencing the transaction. Some customers of virtual currency exchanges in bankruptcy might find themselves in a creditor position, with unknown return. Lenders of digital assets who do not get all or any of their assets return have uncertainty as to the tax treatment of this failed loan that did not involve money.

According to IRS Notice 2014-21, convertible virtual currency is treated as "property." Hence, the taxpayer may easily consider "lending of cryptocurrency" as a type of "rental activity" under section 469. However, section 469(j)(8) defines the term "rental activity" as any activity where payments are principally for the use of tangible property. Cryptocurrency is not "tangible property," therefore, section 469 only applies if the lending involved a trade or business in which individual does not materially participate. Lending of virtual currency raises the issue of whether the return ("interest" and other revenue) is considered portfolio income or business income.

Section 1058, transfers of securities under certain agreements, may seem more relevant in addressing tax impacts in "lending of cryptocurrency." Section 1058 provides that no gain or loss shall be recognized in the case when a taxpayer transfers securities pursuant to an agreement which meets the requirement of Section 1058(b).[27] Per section 1058(a), securities are defined in section 1236(c) which defines security as any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing. The contract or agreement of lending cryptocurrency may be considered as a "security" under section 1236(c), however, the cryptocurrency itself is not considered "security." Therefore, it is not clear whether section 1058 applies to lending of digital assets.

Lacking a clear statute or guidance on how "lending of cryptocurrency" is categorized adds complexity and confusion for taxpayers in reporting income or gain or loss generated from lending of cryptocurrency. There is no doubt that income generated from "lending of cryptocurrency" is taxable under section 61.

If the taxpayer takes the position that "lending of cryptocurrency" is similar to "lending money," then when the "debt" become uncollectible, taxpayers may think they have a bad debt loss with the rules of section 166 applicable. However, Treas. Reg. § 1.166-1(c) requires a "bona fide debt" defined as involving a "valid and enforceable obligation to pay a fixed or determinable sum of money." Given that Notice 2014-21 provides that virtual currency is not money, it appears that section 166 does not apply to a lending of digital assets where the asset is not returned or only partially returned.

There can also be situations where section 166 might apply. For example, if an individual transferred money to an exchange to acquire digital assets, and as a result of bankruptcy of the exchange, the individual becomes a creditor. Could this be viewed in substance as loaning money to a debtor?

<u>Recommendations</u>

Guidance is needed on the treatment of lending of virtual currency or other digital assets under sections 162 (such as if the taxpayer is in a business of "lending" digital assets), 165, 166, 469, 1001, and 1058, and possibly other provisions. This guidance should cover not only losses from "lending" virtual currency and other digital assets, but the categorization of the income generated (portfolio, business or other) and related expenses.[28] This guidance should also address whether

[27] Section 1058(b) provides that "in order to meet the requirements of this subsection, an agreement shall – (1) provide for the return to the transferor of securities identical to the securities transferred; (2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor; (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and (4) meet such other requirements as the Secretary may be regulation prescribe.

[28] We acknowledge that for 2022 and 2023, lending virtual currency and the treatment under section 1001 and section 1058 is on the IRS "no rulings" list for private letter rulings (item #99 of Rev. Proc. 2023-3).

any relationship an investor had with an exchange that started with a cash transfer to the exchange to acquire a digital asset and ended with the customer being a creditor in bankruptcy would be considered a bad debt under section 166.

6. When would section 1234A apply?

Overview

Section 1234A, gains or losses from certain terminations, requires taxpayers to treat gain or loss related to the cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract as defined in section 1234B) with respect to property as gain or loss from a sale of a capital asset if that property is (or on acquisition would be) a capital asset in the hands of the taxpayer.

In Private Letter Ruling (PLR) 200823012, the IRS concluded that section 1234A did not apply with respect to the termination fees the taxpayer received due to the buyer's termination of a proposed acquisition. The IRS did not provide any analysis for why section 1234A did not apply. Rather, the IRS simply concluded that the termination fees to taxpayer were ordinary income because the termination fees were equated to lost profits.

In *CRI-Leslie, LLC*, 147 T.C. 217 (2016), *aff'd* 882 F.3d 1026 (11th Cir. 2018), the Tax Court agreed with the IRS and concluded that a forfeited deposit received by a partnership from a canceled sale of real property was ordinary income. CRI-Leslie entered into an agreement to sell its real property to RPS LLC for $39.2 million. RPS paid a $9.7 million deposit to CRI-Leslie in connection with the sales agreement. However, RPS did not close the sales agreement to purchase the real property therefore RPS forfeited the deposit to CRI-Leslie. CRI-Leslie reported the $9.7 million deposit as long term capital gain under section 1234A. The IRS disagreed, taking the position that section 1234A did not apply because the underlying property with respect to the contract was section 1231 property, and not a capital asset.

In the appellate decision in Pilgrim's Pride Corp., 779 F.3d 311 (5th Cir. 2015), *rev'g* 141 TC 533 (2014), the court went through detailed analysis as to when and how section 1234A applies. The Tax Court previously ruled in favor of the IRS taking the position that section 1234A applies when the taxpayer abandoned securities and that also involved rights to those securities; therefore the loss from such an abandonment was a capital loss under section 1234A instead of an ordinary loss under section 165. The Fifth Circuit disagreed and stated that section 1234A applies to the holder of a right or obligation with respect to property which is a capital asset in the hands of the taxpayer, not the holder of the capital asset itself.

In reviewing the history of section 1234A and the various rulings applying section 1234A, we believe that section 1234A could apply in a specific situations where a taxpayer owns a right or obligation with respect to property which is or would be a capital asset in their hands. In the digital asset world, this might be a situation where a taxpayer is given the right to purchase a specific digital asset, such as a token, an NFT, or any securities involving digital assets where the underlying digital asset is a capital asset in the hands of the taxpayer.

For example, Taxpayer A, an individual investor, is given the right to purchase an interest in Simple Agreement for Future Tokens (SAFT). This right to purchase a SAFT is a right to property which is a capital asset in the hands of Taxpayer A. If Taxpayer A purchases the right, and subsequently generates a loss due to cancelation, lapse, expiration or termination of the right, Taxpayer A will have section 1234A capital loss. If, on the other hand, Taxpayer A purchases the cryptocurrency token directly under the SAFT arrangement and suffers a loss, it may still be a loss deductible on the taxpayer's tax returns but it is not a section 1234A capital loss because Taxpayer A owns the underlying capital asset directly (owns the asset outright) (as in the *Pilgrim's Pride Corporation* case).

Recommendations

Guidance is needed on when and how section 1234A applies to digital assets, particularly regarding assets lost or cancelled due to bankruptcy of an exchange. In addition, guidance should be issued if the IRS does not agree with the Fifth Circuit's decision in *Pilgrim's Pride Corporation*, which overturned the Tax Court decision where the IRS's interpretation of section 1234A was upheld.

7. What to do if a taxpayer cannot access their records due to bankruptcy.

Overview

During 2022, several centralized cryptocurrency exchanges, including FTX, Celsius, Voyager, and BlockFi, filed for bankruptcy and halted customer account access. Given that these were centralized exchanges, the customer activities did not happen on a blockchain, leaving taxpayers without any records of their transactions within the centralized exchange.

Section 6045 was intended to be applied to digital asset transactions beginning with transactions on January 1, 2023, so that brokers were required to supply taxpayers with cost basis information on their digital asset transactions. Section 6045 implementation has since been delayed until final regulations are published per IRS Announcement 2023-2. However, section 6045 requirements still would not have been applicable to transactions in 2022.

Recommendations

Guidance should be issued to provide that taxpayers with activity on a centralized exchange that filed for bankruptcy are not required to report on their federal income tax return activity from a centralized exchange in the year the centralized exchange files for bankruptcy due to substantial risk of forfeiture[29] if all the following items are met:

[29] Under section 83.

- The taxpayer had an account on a centralized exchange.
- The centralized exchange filed for bankruptcy protection.
- The bankruptcy procedures are still in process.
- The taxpayer's assets are still custodied by the exchange.

This guidance should provide that taxpayers are still required to report all activity from other sources where the taxpayer has access to their activity log.

Treasury and IRS should provide that taxpayers who do not meet the four-prong test above who withdrew their assets from the exchange before the bankruptcy filing should reconstruct their basis and refer to records of withdrawals to reconstruct proceeds.

Building on the scenario above where a taxpayer withdrew their assets before the exchange filed bankruptcy, guidance should provide a safe harbor for determining the holding period of taxpayer's gains and losses that is similar to section 1256 contracts where the gain or loss is split 60/40 between short-term and long-term holding periods.

8. Can a digital asset be disposed of by transferring interest in a bankruptcy proceeding?

<u>Overview</u>

The 2022 bankruptcy filings by Voyager Digital and Celsius Network and FTX's bankruptcy highlight the question of whether crypto assets held by an exchange or similar platform may be considered property of a bankruptcy estate and therefore, not recoverable by a customer, who likely would then be an unsecured claim holder of the debtor. Whether crypto assets are property of the bankruptcy estate will be governed by applicable non-bankruptcy law, which is primarily state law. Bankruptcy courts may come to different conclusions depending on the state law that applies. Layer on the Internal Revenue Code and related Treasury Regulations that were enacted and promulgated prior to the advent of digital currency. Now add to the mix a vibrant market for the sale and purchase of creditors' Voyager Digital, Celsius Network, and FTX bankruptcy claims.

Because of these legal cross currents, taxpayers and their advisors are seeking guidance about:

1. If a taxpayer sells their bankruptcy claim, have they disposed of their crypto assets and realized a loss equal to the difference between what they received and the cost basis of their crypto assets?

   Is this loss tax recognizable?

   If it is, what type of loss is it?

2. Are the bankruptcy claim and the taxpayer's unsecured creditor claim separate assets?

3. Can a taxpayer claim a loss for crypto assets held for investment that became an unsecured creditor claim?

   When is this loss recognized?

   What type of loss is it?

Recommendations

Guidance is needed and requested with respect to the above. Due to nature of these bankruptcies, how the crypto assets were held by the exchanges, and for federal income tax purposes, cryptocurrency being treated as property, which is not a security, Treasury and IRS should provide clarity as to which Internal Revenue Code sections are applicable. Illustratively, with respect to claiming a bad debt deduction, Treas. Reg. § 1.166-1(c) states the "Only a bona-fide debt qualifies for purposes of section 166. A bona-fide debt is a debt that arises from debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." Notice 2014-21 provides that virtual currency is not money. It appears that section 166 does not apply to a lending of digital assets. Cryptocurrency is not money. Accordingly, Treasury and IRS should provide clarity needed regarding whether a bad debt deduction even be claimed with respect to it.

Furthermore, there is a pending lawsuit alleging Celsius Network was a Ponzi scheme. This adds another twist to this drama.

To address all of these concerns, we recommend that perhaps Treasury and IRS could consider addressing the federal income tax ramifications of the Voyager Digital, Celsius Network, and FTX bankruptcies, and the buying and selling related bankruptcy claims in manner similar to the "Madoff ruling" (Rev. Proc. 2009-20).

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We appreciate your consideration of these comments and welcome the opportunity to discuss these suggested FAQs and issues further. If you have any questions, please contact Annette Nellen, Chair, AICPA Virtual Currency Task Force, at (408) 924-3508 or Annette.Nellen@sjsu.edu; Peter Mills, AICPA Senior Manager – Tax Practice & Ethics, at (202) 434-9272 or Peter.Mills@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,

Jan Lewis, CPA
Chair, AICPA Tax Executive Committee

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