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Crypto Traders Wrestle With Export Deduction Qualification

By **Alex M. Parker**

Law360 (April 5, 2019, 7:54 PM EDT) -- Cryptocurrency sales may qualify for a substantial deduction on exports from the 2017 tax law, but dealers and traders face technical and legal hurdles to verify the geography of an asset that, by its very design, almost entirely exists on the web.

U.S. Treasury officials admit they've barely begun to explore the definitional and practical questions surrounding cryptocurrencies while companies involved with cryptocurrencies begin to explore whether they can claim the benefit.

Companies that use cryptocurrency are trying to determine when a crypto is "used" offshore and to create a record verifying the location of the use as well as the user. Above is a bitcoin ATM in Hong Kong. (AP)

The questions largely hinge on whether crypto sellers can pin down who and where their buyers are and what they ultimately do with the currency.

"I would guess that if you're selling to a foreign person, and the foreign person uses it for something, it probably would be for foreign use," said Lisa Zarlenga, a partner with Steptoe & Johnson LLP in Washington, D.C. "But you'd have these technical requirements. It's on the blockchain. Is it used anywhere?"

Blockchain is the ledger system for cryptocurrencies. Created as the accounting system for bitcoin, the first and most popular cryptocurrency, it operates through a distributed, peer-to-peer network without a central controller. No one person or entity approves or rejects transactions — users record transactions through encrypted keys, and once they're recorded they become part of the blockchain forever. In the case of bitcoin, encrypting new entries into the blockchain, known as mining, requires massive computing power and is the primary limit for the currency's supply.

Most crypto buyers and sellers just buy it for themselves, intrigued by the dazzling new technology or convinced that it could be a lucrative investment. But for a small minority, it's a serious business — they "mine" cryptocurrencies for sale, buy and sell them as an exchange, or use them to act as an intermediary for other kinds of currency exchanges. Other companies incorporate them into their very business, using cryptocurrency "tokens" as part of a transaction for some other service, or offering them as a means of investment through an initial coin offering.

For those users, claiming the Tax Cuts and Jobs Act's 37.5% deduction on foreign-derived intangible income is an intriguing, but challenging, possibility.

FDII is a key plank in the TCJA's international framework, providing an incentive for U.S. companies to keep their valuable intangible assets, such as intellectual property, at home. The law defines intangible income as income earned beyond 10% of a company or entity's depreciable tangible assets. Through the deduction, the TCJA taxes FDII at a 13.125% rate, similar to the 10.5% rate on global intangible low-taxed income, or intangible income held by a foreign subsidiary.

But FDII is available only to income that is "foreign-derived," or from sales to a foreign person for foreign use. The law gave Treasury wide powers to define what foreign consumption is, and lay out documentation requirements for taxpayers to establish it.

For companies in the cryptocurrency sphere, the challenge is twofold: determining when a cryptocurrency is "used" offshore, and coming up with a record verifying not only the location of the use but of the user.

"Those are the big practical questions at the front end, that everybody's grappling with," said Brian Rowbotham, a tax partner at Crowe LLP in San Francisco. "Companies are grappling with this today, and they're just having to take positions."

Treasury has had little to say about cryptocurrencies generally since 2014, when it issued a notice stating that they're considered assets for tax purposes.

Marissa Rensen, senior counsel at the IRS Office of Chief Counsel, told Law360 the agency had yet to focus on the particular issue of cryptos and FDII.

"The hard part is defining what it is," she said. "I think it's something that we're aware of servicewide, that there are lots of issues with cryptos. That said, I don't know that we've done a lot of deep thinking on it for FDII purposes, I think comments would be appreciated."

It may be that some cryptocurrencies don't qualify at all. The proposed regulations specify that taxpayers cannot claim the FDII deduction on the sale of commodities or securities, which may include some types of cryptocurrency sales. Initial coin offerings, for instance, are seen as analogous to initial public offerings of stock, as buyers purchase means of investment in a venture.

The Securities and Exchange Commission is still outlining whether and when ICOs can be seen as an offering of securities. On Tuesday, it issued a no-action letter allowing an unregistered ICO from a charter air service, noting that the tokens didn't offer a piece of future profits but rather a guarantee of air travel.

The proposed regulations also distinguish between sales and services, even though the deduction is ultimately available to both.

"They both qualify, but it's different how they apply," said Zarlenga, of Steptoe & Johnson. "That would be another hurdle to get over."

But the biggest challenge will be determining the location of a cryptocurrency's use. Cryptocurrencies can be stored and traded, and their uses can vary from token to token.

“You’ve got different sales to a fund to participate in some token ICO, and very quickly the tokens could end up getting traded in different exchanges,” Rowbotham said. “From a practical point of view, how do you know where it’s used?”

And many of those exchanges would happen entirely online — not on a centralized server hosted by a single company, but through the cloud-based, peer-to-peer networks that comprise the blockchain.

“What do we provide the IRS with for documentation, when you're basically dealing with a distributed ledger that doesn't give you a bank statement?” Rowbotham said.

Furthermore, users of cryptocurrencies are likely to be reluctant to provide identifying documentation to verify that they’re not located in the U.S. Since their creation, cryptocurrencies have been prized by those looking for anonymous and untraceable ways to conduct transactions.

“The individuals who are buying them may not want to identify themselves, to the extent that is necessary,” said Nelson Yates, of counsel at Morgan Lewis & Bockius LLP. “When you think about cryptocurrencies, a big draw is the ability to be anonymous.”

Cryptocurrencies are just one of many situations where companies may provide nontraditional virtual services or products that can be difficult to pin down. While the law gives Treasury wide latitude to determine the qualifications, officials have admitted that devising consistent rules has been challenging.

Despite the headaches, the 37.5% deduction on income designated as FDII is a major draw for companies operating within the U.S. If the income can be sourced to the U.S., the taxpayer can claim the lower rate without worrying about foreign taxes or the foreign tax credit limitations that can be triggered by GILTI.

“If you have IP software in the cryptocurrency context, having that intellectual property held by a U.S. suddenly becomes very appealing,” said Patrick McCormick of Drucker & Scaccetti in Philadelphia.

--Editing by Tim Ruel and John Oudens.

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