TAX ASPECTS OF CRYPTOCURRENCY WITH A FOCUS ON THE TAX ASPECTS OF INITIAL COIN OFFERINGS

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A few months ago, I published an article on the tax aspects of cryptocurrency: a few thoughts on the tax aspects of this new digital asset. Little did I appreciate that the tax world is clamoring for more information on cryptocurrency, as I quickly realized after the article generated significant email, phone calls, and discussion.

One primary question came from these inquiries: What about the tax treatment of initial coin offerings? Good question—and a question without a simple answer. In this article, we will review the possible answers to this question as well as review some of the basics of the tax aspects of cryptocurrency.

WHAT IS CRYPTOCURRENCY?

As a starting point, we should define 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 (or 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, it seems to be accepted by some in the cryptocurrency community that the real creator is Craig Wright, an entrepreneur from Australia.[5] The mystery remains.

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 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. This 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] We'll discuss the Notice in detail below. It is highly relevant to analyzing the tax aspects of initial coin offerings.

In September 2016, the U.S. Treasury Inspector General for Tax Administration ("TIGTA") released a report on the use of virtual currencies in taxable transactions and additional actions that are needed to ensure taxpayer compliance (the "Report").[15] The Report acknowledges the Notice, but states that "there has been little evidence of coordination between the responsible functions to identify and address, on a program level, potential taxpayer noncompliance issues for transactions involving virtual currencies."[16] The Report further finds that the IRS had not coordinated efforts among its various divisions to ensure taxpayer compliance in virtual currency tax reporting or to coordinate examination or investigations specific to virtual currency tax noncompliance. The Report concludes by recommending a series of actions that the IRS should take, including developing certain coordinated virtual currency strategies, providing updated guidance to reflect the necessary documentation requirements and tax treatments for the various uses of virtual currencies and revising third-party information reporting documents to identify the amounts of virtual currencies used in taxable transactions. We have yet to become aware publicly that the IRS has implemented all of the Report's recommendations, but the Report gives reason to believe that the IRS has already undertaken some preliminary work to implement at least some recommendations made in a prior draft of the Report.

In February 2018, Coinbase, Inc. ("Coinbase") notified a group of approximately 13,000 customers that it received a summons from the IRS regarding their Coinbase accounts.[17] Coinbase is one of the world's largest virtual currency exchanges, so this was a highly significant occurrence. Coinbase was ordered to provide the taxpayer identification numbers, names, birth dates, addresses and certain historical transaction records with respect to customers engaged in certain higher-value transactions (specifically, those with at least the equivalent of $20,000 in any one transaction type (buy, sell, send, or receive)) during the years 2013 through 2015.[18] Clearly, the IRS is getting more interested in the tax gap that may be attributable to noncompliance in virtual currency tax reporting.

Most recently, on March 23, 2018, the IRS released IR-2018-71, in which it reminded taxpayers that virtual currency transactions are taxable by law just like transactions in any other property. The IRS emphasized that taxpayers should report virtual currency transactions to the extent required under the principles of the Notice or else risk liability for tax assessment upon audit, including when appropriate liability for penalties and interest.[19]

In short, it looks like the IRS is coming for cryptocurrency.

THE NOTICE

Let's circle back for a moment to the Notice so as to understand how the IRS treats cryptocurrency from a tax perspective. The purpose of the Notice is to describe how existing general tax principles apply to

transactions using virtual currency.[20] 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."[21] 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.[22] While it is 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."[23] 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.[24] 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).[25]

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.[26] 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.[27] 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."[28] What this means is that if I purchase a good with Bitcoin, I would need to make a determination of gain or loss based on the exchanged portion of my Bitcoin adjusted basis at the time of purchase. I would also need to report any gain or loss on my income tax return.

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.[29] 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.[30] 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.[31]

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 likely 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 of convertible virtual currency 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 applications that allow 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 the colloquial view among the general public and the legal view within the IRS.

Further, 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 an adjusted 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 a practical requirement under the current tracking systems (or lack thereof) provided to cryptocurrency users. 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 perhaps not because that could be ultimately used in an abusive manner.

Nevertheless, in and of itself, the property characterization makes sense from a tax perspective and a basis requirement must be made. To help identify adjusted tax basis for blocks of cryptocurrency, it may be helpful to look at other intangible 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 that 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.[32] 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.[33] 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.[34] These rules are specific to stock. In many ways, cryptocurrency is similar to stock in that it may be purchased in separate blocks on 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.

Perhaps the big takeaway from the Notice for those engaging in cryptocurrency transactions is that recordkeeping is essential. Taxpayers should use reasonable efforts to track their cryptocurrency exchanges, purchases, sales and other transactions, including the value of the cryptocurrency used in the transaction and the adjusted basis of the cryptocurrency (in U.S. dollars). There are not many resources yet to help taxpayers with these recordkeeping practices, but there are a few. For example, LibraTax promises to track cryptocurrency activity and establishes cost basis to calculate capital gains and losses and report taxable events.[35] Coinbase has also taken steps to help users track their cryptocurrency transactions undertaken on the Coinbase exchange by posting an FAQ section on its website with guidance on the tax issues surrounding cryptocurrency, including a reference to the Notice.[36] Coinbase states on the website that it will provide IRS Forms 1099-K to certain customers that have received at least $20,000 in cash for sales of virtual currency related to at least 200 transactions in a calendar year. Further, Coinbase launched a new report, a Cost Basis for Taxes report (in beta), which promises to help users in filing their taxes with respect to virtual currency.

INITIAL COIN OFFERINGS

With all this guidance in mind, we can start to look at the tax treatment of initial coin offerings. By way of background, initial coin offerings are undergoing explosive growth in recent years and have the feel of a wild, wild West atmosphere due to lack of regulation. In fact, because of this lack of regulation and the potential scams surrounding initial coin offerings, the Securities and Exchange Commission ("SEC") issued a tongue-in-cheek warning to initial coin offering

participants by setting up a mock initial coin offering website that boasts of amazing guaranteed returns (check out the website here: https://www.howeycoins.com/index.html).[37] What is perhaps more troubling is that when I sent out a link to the SEC's website as a joke to some friends, not all of them got the joke and instead thought it might be a real investment opportunity. That should give you a good idea of the current initial coin offering environment.

That being said, there are many legitimate initial coin offerings in the market where the issuer is using efforts to operate in full compliance with all applicable laws in conducting its offering. In these cases, the initial coin issuers are disrupting the existing venture capital and angel investor market to provide a new source of funding for their businesses—and often doing so successfully.

Typically, an initial coin offering is the offering of a so-called "token." Unlike more traditional fundraising ventures, initial coin offerings do not necessarily offer any equity interest in the issuer itself. Instead, the tokens offered in the initial coin offering typically allow a buyer a prospective right to some future, to-be-developed product or service of the issuer. Having said that, the combinations of terms for initial coin offerings are infinite, and some tokens come with equity rights or rights similar to equity, rights to share in business profits and voting rights in addition to a prospective right to a service or good. In lieu of a right to services, some tokens are expected to be "bought back" by the issuer as a way to cash in on the blockchain platform created. The types of tokens generally vary from utility tokens (which provide the holder with access to a bespoke blockchain platform including products or services) to security tokens, which are generally more akin in substance to equity or debt instruments.

The tokens are typically described in a "White Paper" prepared by the issuer and released to prospective buyers for their review, often on the issuer's website. Tokens issued in initial coin offerings may be offered for cash or for other cryptocurrencies, such as Bitcoin or Ether.

Despite the explosive growth of initial coin offerings in recent years, little attention has been paid to the U.S. federal income tax treatment of initial coin offerings. Importantly, the type of token at issue is highly relevant to the tax analysis because any tax analysis is based on application of the Notice to the facts-and-circumstances of the initial coin offering. Given the newness of the industry, there is no "standard" utility token offering facts or "standard" security token offering facts. Instead, each initial coin offering varies—often significantly. With such variance, there are no tax conclusions that can be applied to all initial coin offerings.

What are issuers and initial coin offering participants to do? Unfortunately, until the IRS releases further guidance on these issues, issuers and participants are left to analyze each initial coin offering based on its facts and circumstances. Let's look at some options in more detail. An important caveat before we turn to the various options: it is assumed herein that the token issuer is subject to U.S. federal income tax. This is not always a clear result, particularly because many issuers are formed offshore in no- or low-tax jurisdictions. The complexity that goes along with offshore issuers cannot be understated on the U.S. tax side. Any offshore issuer subject to U.S. tax needs to consider a host of international tax rules (U.S. and non-U.S.) that may be implicated in its offering. Similarly, any taxpayer subject to U.S. tax participating in such an offering needs to tread carefully to navigate the U.S. international tax rules that could apply to the offering, including certain anti-deferral regimes such as the "controlled foreign corporation" anti-deferral regime and "global intangible low-taxed income" anti-deferral regime, as well as any applicable non-U.S. tax issues. These issues are not further discussed herein.

With that caveat, let's turn back to the options. First, recall that the Notice treats convertible virtual currency as property for U.S. federal income tax purposes. Assume an initial coin offering offers a token that is a convertible virtual currency. This type of token likely falls within the bounds of the Notice. As such, the receipt by the issuer of cash or other property (including other cryptocurrency) in exchange for the token is generally a realization event for U.S. federal income tax purposes—just like any other barter transaction.

An offering of this type could be considered for tax purposes as a prepayment for future services, the service being the ongoing maintenance and upkeep of the blockchain supporting the token. This type of prepayment for future services has been held by courts in certain cases to be taxable upon the prepayment and not upon the future provision of services.[38] This is because Code Section 61 and the underlying Treasury

Regulations generally require that gross income means all income from whatever source derived unless excluded by law.[39] As such, gross income would include income from barter transactions and generally from prepaid services contracts as well. For many issuers, this treatment results for the initial coin offering issuer in a large upfront income recognition event in the year of the offering. This is likely the result for most issuers of utility tokens, which will often be treated as property for U.S. federal income tax purposes as opposed to stock or debt (although, as always, a facts-and-circumstances analysis may dictate otherwise).

What about a Code Section 1031 exchange, you say? Couldn't that be applied to avoid issuer-side income recognition? We will get to that in more detail in a bit—but in short, no Code Section 1031 exchange treatment is available for cryptocurrency exchanges as of January 1, 2018.

What about security tokens? Security tokens are perhaps more interesting from a tax perspective because they could be treated—if the facts and circumstances are appropriate—as stock or debt for U.S. federal income tax purposes. If stock, under Code Section 1032(a), no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation. In other words, the security token when treated as stock for U.S. federal income tax purposes does not result in income recognition to a corporate issuer. If debt, a similar result applies: the token issuer does not recognize income upon receipt of a loan for U.S. federal income tax purposes. However, both of these characterizations—stock and debt—require that the issuer be comfortable that it has a tax reporting position that the security token is in fact stock or debt for U.S. federal income tax purposes and not some other intangible property. This requires an analysis to see how the token is likely to be treated. The determination of whether an instrument should be classified as debt or equity for U.S. federal income tax purposes is governed by case law[40] and is based on all of the facts and circumstances relating to the particular instrument.[41]

For example, the courts have developed a number of debt-equity factors that are used in determining whether an agreement constitutes debt. In several debt-equity cases, the Fifth Circuit listed and analyzed some of the factors that have been previously identified by the U.S. Tax Court and the Eleventh Circuit Court of Appeals.[42] These factors are as follows:

1. The names given to the certificates evidencing the indebtedness;
2. The presence or absence of a fixed maturity date;
3. The source of payments;
4. The right to enforce payment of principal and interest;
5. Participation in management as a result of the advance;
6. The status of the contribution in relation to regular corporate creditors;
7. "Thin" or adequate capitalization of the borrower;
8. Identity of interest between the creditor and stockholder;
9. The source of interest payments;
10. The ability of the corporation to obtain loans from outside lending institutions;
11. The extent to which the advance was used to acquire capital assets;
12. The failure of the debtor to repay on the due date or to seek a postponement; and
13. The intent of the parties.

The identified factors are not equally significant, and no single factor is determinative in each case or relevant in every case.[43] Further, these factors do not necessarily easily lend themselves to the initial coin offering context—so analogies would often need to be drawn. However, these are the types of factors that an issuer should consider in determining whether a token is stock or debt for U.S. federal income tax purposes.

What if an issuer issues tokens that clearly cannot be treated as stock or debt for U.S. federal income tax purposes? Are there any other ways to avoid the upfront tax hit for an issuer in the year of the offering? Perhaps yes, although this result is unclear. The IRS released a private letter ruling on June 2, 2017 (PLR 201722004) that could be a useful analogy to some initial coin offerings and, if the facts are appropriate, results in a reasonable position that the income generated in the initial coin offering is deferred. In PLR 201722004, a corporate taxpayer entered into a contract to, among other things, grant the right to enter into a limited

number of personal seat license arrangements. In turn, certain parties paid for these rights and had a right to the personal seat licenses from the corporate taxpayer. A personal seat license is a license issued by a professional sports association that provides the holder of the right with the opportunity to buy season tickets for the relevant games. However, in this case, this right was redeemable by the corporate taxpayer. In PLR 201722004, the IRS found that the proceeds that the corporate taxpayer received were not gross income to the corporate taxpayer at the time of receipt because the proceeds were subject to the corporate taxpayer's legally enforceable and binding obligation to repay the proceeds if the parties to the personal seat license contracts did not buy any season tickets. In other words, the corporate taxpayer had an outstanding liability to either fulfill the personal seat licenses by providing season tickets or repay those with whom it had contracted for their license. Because of this, the corporate taxpayer did not have the requisite complete control over the proceeds paid for the personal seat licenses that was required (in the IRS's view) for the proceeds to be gross income to the corporate taxpayer within the meaning of Code Section 61.

Similar to the facts under PLR 201722004, one could imagine an initial coin offering where tokens issued by an issuer are subject to a binding refund if the issuer does not fulfill a promise to create a particular platform or provide access to a particular exchange. Perhaps in such cases the issuer could argue that it is not required to recognize income upon the issuance of the tokens because it does not have the requisite control over the proceeds accepted for those tokens (in other words, the issuer may be bound to repay the purchasers of the tokens) in the year of issuance. It is difficult to predict whether the IRS would agree with this result, even in situations with highly similar facts to PLR 201722004. Notably, a private letter ruling of this nature may not be relied upon by any taxpayer other than the taxpayer for whom it was issued. In other words, PLR 201722004 does not bind the IRS. Thus, while this guidance is helpful to review and consider its application, if any, to an initial coin offering, the IRS may disagree that tokens issued in an initial coin offering are subject to the guidance under PLR 201722004.

The above looks at the U.S. federal income tax treatment of token issuers. Of course, token purchasers also need to be considered. As a general matter, the purchase of a token treated as property (but not stock or debt) for U.S. federal income tax purposes with cash (as opposed to with another cryptocurrency) will not be a taxable event to the purchaser. Instead, the purchaser acquires an asset that may be capital or ordinary in nature depending on the purchaser's reasons for the acquisition, just as any property acquired, and typically has a cost basis. However, any subsequent exchange, sale or other transaction involving the purchased token (such as cashing in the token for services of the issuer) would need to be reviewed to determine the tax aspects triggered by the later transaction. Moreover, if tokens are purchased by a purchaser with cryptocurrency, the purchaser may have engaged in a barter transaction, which may in turn have triggered gain or loss for U.S. federal income tax purposes (see also below discussion on Code Section 1031 exchanges). If the tokens acquired are more appropriately treated as stock for U.S. federal income tax purposes, the purchaser needs to be mindful of any buybacks of the token, as these buybacks could be treated as dividend income to the purchaser for U.S. federal income tax purposes.[44]

Like Kind Exchanges of Cryptocurrency

As noted above, given that cryptocurrency is treated as property for U.S. federal income tax purposes, it may benefit from a like kind exchange under the provisions of Code Section 1031. Perhaps exchanging one Bitcoin for another Bitcoin could be accomplished in a tax-deferred manner under Code Section 1031. Also, recall from the above discussion that there are other cryptocurrencies aside from Bitcoin. Well, why not exchange one for another and call it tax-deferred! Could this not also apply in an initial coin offering?

It is clear that any completed Code Section 1031 exchanges in tax years beginning in 2018 are limited to those of real property, and so Code Section 1031 would not apply to cryptocurrency exchanges made after December 31, 2017, including as part of an initial coin offering. This is due to a recent change in law effected under 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 are feasible from a tax perspective, although there are traders in the cryptocurrency market effecting them.[45] If a Code Section 1031 exchange is valid using cryptocurrency, an exchanger

would be able to avoid gain recognition upon 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 also the threshold matter of how Code Section 1031 may apply to cryptocurrency at all.

By way of background, as in effect prior to 2018, Code Section 1031 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.[46] 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[47] 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.[48] The benefits of Code Section 1031 (as applied 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.[49] 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 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 in tax years beginning before 2018.

The question next becomes whether one cryptocurrency could be exchanged in tax years beginning 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.[50]

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 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.[51] This is a like kind exchange for Code Section 1031 purposes. 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.[52] 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.[53] 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.[54] The IRS stated that the values of the silver bullion and the gold bullion are determined solely on the basis of their metal content.[55] 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."[56] In another instance, the IRS reviewed an exchange of U.S. gold coins that were held for investment purposes.[57] 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."[58] 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."[59] 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."[60] 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."[61] In light of these differences in character, the coins could not be exchanged under Code Section 1031(a). In contrast, in nonbinding 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.[62] In such case, the gold bullion bars were being held for investment purposes. The IRS found 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 Code Section 1031 purposes 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 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.[63] 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.[64]

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? It appears that there is some significant risk that they cannot.

Even the idea that a Bitcoin-for-Bitcoin exchange may constitute a Code Section 1031 exchange in prior tax years, as suggested above, may be doubtful as these technologies have evolved. By way of example, on August 1, 2017, Bitcoin essentially "split" into two markets: Bitcoin and "Bitcoin Cash," or "BCC."[65] This split was caused by a split from the underlying "blockchain" upon which Bitcoin operated as a technical matter,[66] and by a split among Bitcoin users regarding the degree which Bitcoin should grow and scale as a more global matter.[67] Could Bitcoin have been exchanged for BCC in a Code Section 1031 exchange in tax years beginning prior to 2018, or are the two cryptocurrencies 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 in light of the recent change in law limiting Code Section 1031 exchanges to real property.

CONCLUSION

Welcome to the wild, wild West. While it is helpful that the Notice was issued so that taxpayers can, at a minimum, review their cryptocurrency transactions in light of the guidance therein, the Notice leaves much to be desired in terms of answers to common tax questions involving cryptocurrency. Until further guidance is issued, taxpayers are left to use a facts-and-circumstances analysis to review these questions—including, notably, the U.S. federal income tax treatment of initial coin offerings.

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; 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 https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf.

16 Report, see "Highlights."

17 https://support.coinbase.com/customer/portal/articles/2924446-irs-notification.

18 http://assistly-production.s3.amazonaws.com/75687/kb_article_attachments/128798/CoinbaseOrder_original.pdf?AWSAccessKeyId=AKIAJNSFWOZ6ZS23BMKQ&Expires=1526949179&Signature=17JakP86VIMJyb66O%2FKPu%2FWUoHc%3D&response-content-disposition=filename%3D%22CoinbaseOrder.pdf%22&response-content-type=application%2Fpdf.

19 https://www.irs.gov/newsroom/irs-reminds-taxpayers-to-report-virtual-currency-transactions.

20 Id.

21 Id.

22 As noted above, although Bitcoin may be the most well-known cryptocurrency, there are in fact many other types of cryptocurrencies.

23 IRS Notice 2014-21.

24 Id.

25 Id.

26 Id., §4, Q-4.

27 Id., §4, Q-5.

28 Id., §4, Q-3.

29 Id., §4, Q-7.

30 Id.

31 Id.

32 U.S. Treas. Reg. §1.1012-1(c)(1)(i).

33 U.S. Treas. Reg. §1.1012-1(c)(1)(ii).

34 *Id*.

35 https://app.libratax.com.

36 https://support.coinbase.com/customer/en/portal/articles/1496488-taxes-faq.

37 https://www.sec.gov/news/press-release/2018-88.

38 See Auto. Club of Mich. v. Comm'r, 353 U.S. 180 (1957); Am. Auto. Ass'n v. United States, 367 U.S. 687 (1961); Schlude v. Comm'r, 372 U.S. 128 (1963); but see Perry Funeral Home Inc. v. Comm'r, T.C. Memo 2003-340.

39 Unless otherwise stated herein, references to the Code are to the U.S. Internal Revenue Code of 1986, as amended.

40 Note also that Code Section 385(b) lists five factors that may be considered that tend to show whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. Further, IRS Notice 94-47, 1994-1 C.B. 357, sets forth eight factors intended to distinguish debt from equity. The factors listed in Code Section 385(b) and in Notice 94-47 are largely duplicative of the factors identified by various courts.

41 Notice 94-47; see also John Kelley Co. v. Comm'r, 326 U.S. 521 (1946).

42 See, e.g., Texas Farm Bureau v. United States, 725 F.2d 307, 311 (5th Cir. 1984) (considers following 13 factors: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement), cert. denied, 469 U.S. 1106 (1985); Slappey Drive Indus. Park v. United States, 561 F.2d 572 (5th Cir. 1977) (same factors); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (same factors); Dillin v. United States, 433 F.2d 1097 (5th Cir. 1970) (same factors); Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969) (same factors); Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969) (same factors); Curry v. United States, 396 F.2d 630 (5th Cir.) (same factors), cert. denied, 393 U.S. 967 (1968); Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967) (same factors); United States v. Snyder Bros. Co., 367 F.2d 980 (5th Cir. 1966) (same factors), cert. denied, 386 U.S. 956 (1967); Montclair, Inc. v. Comm'r., 318 F.2d 38 (5th Cir. 1963) (same factors); Rowan v. U.S., 219 F.2d 51 (5th Cir. 1955) (same factors). See also Parisian, Inc. v. Comm'r., 131 F.2d 394 (5th Cir. 1942) (essential feature of a debtor-creditor relationship is the existence of a fixed maturity with the right to force payment); United States v. S. Ga. Ry., 107 F.2d 3, 5 (5th Cir. 1939) (the court emphasizes the importance of the right of the holder to enforce payment).

43 See Jones v. United States, 659 F.2d 618, 622 (5th Cir. 1981); Calumet Indus., Inc. v. Comm'r, 95 T.C. 257, 285 (1990).

44 See generally Code Section 302(b)(1).

45 *See* https://www.forbes.com/sites/greatspeculations/2017/08/15/cryptocurrency-traders-risk-irs-trouble-with-like-kind-exchanges/#13de44cb26a8.

46 Code Section 1031(a)(1). Note that gain realized on a Code Section 1031 exchange does need to be recognized to the extent that certain recapture provisions under the Code are implicated (namely, Code Sections 1245 and 1250). Code Sections 1245(b)(4) and 1250(d)(4).

47 In this case, by "money," I mean what we typically think of as money: coins and banknotes.

48 Code Section 1031(d).

49 Code Section 1031(a)(2).

50 Treas. Reg. Section 1.1031(a)-1(d).

51 Treas. Reg. Section 1.1031(a)-2(c)(3), Example 1.

52 Treas. Reg. Section 1.1031(a)-2(c)(3), Example 2.

53 This assumes that all other relevant requirements necessary for a Code Section 1031 exchange are met.

54 Rev. Rul. 82-166, 1982-2 C.B. 190.

55 Id.

56 Id.

57 Rev. Rul. 79-143, 1979-1 C.B. 264.

58 Id.

59 Id.

60 Id.

61 Id.

62 PLR 8117053.

63 https://www.forbes.com/sites/quora/2017/09/14/how-is-ethereum-different-from-bitcoin/#388eef37502b.

64 http://blog.bnktothefuture.com/icos-disrupting-equity-can-expect-bnktothefuture/.

65 https://www.cnbc.com/2017/08/02/bitcoin-cash-rallies-blockchain-split-digital-currency.html.

66 Id.

67 https://www.coindesk.com/coindesk-explainer-bitcoin-cash-forking-blockchain/.