

Tax Pros Scrambling, Guessing On Sourcing Of Cryptos

By **Alex M. Parker** · September 26, 2018, 9:16 PM EDT

The Internal Revenue Service has created a headache for practitioners advising cryptocurrency holders by promising to crack down on these unique digital assets while providing minimal guidance for determining the location of items that consist of little more than internet code.

Since 2014 — when the IRS issued guidance classifying cryptocurrencies as assets for tax purposes — tax professionals have been doing their best to determine how to apply existing tax rules on the digital currencies, which are recorded in online, decentralized ledgers known as blockchains. But that scant, 4-year-old IRS guidance leaves most issues relating to cryptocurrencies unresolved, according to practitioners. This is true especially with problems on how to source the income from cryptos, which by their very nature can be difficult to pin down to any location.

Tax advisers are even at a loss to explain when a cryptocurrency is clearly foreign, and thus subject to the reporting requirements of the Foreign Account Compliance Act. The standard applied by Supreme Court Justice Potter Stewart to pornography — you'll know it when you see it — is about the best anyone in the tax world can do.

"At the time, there isn't any guidance," said Sahel Assar, international tax counsel at Buchanan Ingersoll & Rooney PC. "Taxpayers have to proceed with caution. They can either overreport or underreport, neither of which is good policy."

In just a few years, cryptocurrencies grew from a curiosity on some of the farthest corners of the web to a billion-dollar industry and Wall Street darling. The "currencies" are recorded in blockchain, a ledger technology that allows users to encrypt entries of new transactions, which are protected from theft and prying eyes.

In the case of many cryptocurrencies, including bitcoin, the complexity of the encryption process serves



Cryptocurrencies, such as bitcoin, by nature are difficult to tie to a location, making it problematic to source income from them. (AP)

to limit the amount of the currencies and increases their value. Huge fields of computer servers are dedicated toward adding new encrypted entries — the process is known as mining — just for the chance to grab some of this digital gold.

Without any international consensus, the world's tax authorities have slowly begun to investigate some of the issues with sourcing and allocating the income from cryptocurrencies — which can often be very valuable. Many have found that the usual residence of the owner can be a useful proxy in most situations but cannot be the entire rule. The U.S., however, is behind.

The IRS has issued guidance, mostly in a question-and-answer format, expressing its view that cryptocurrencies are assets. But the guidance gave no clues as to how the IRS might look at sourcing or location, along with a host of other issues that have become more apparent as cryptocurrencies have continued to soar in value.

Despite the minuscule guidance, the IRS in July announced it was spearheading an enforcement campaign on cryptocurrencies, baffling some accountants as the campaign announcement shed little light on what rules it would be enforcing. The backlash to this announcement has grown so severe that several Republican lawmakers wrote a letter to the IRS demanding more guidance before aggressive enforcement begins.

The situation has left most tax advisers trying to figure out which parts of the existing revenue code fit.

“There's not a lot to really rest on, except to rest on imperfect, analogous situations, and see if we can get comfortable with how this should get sourced,” said Nelson Yates, of counsel at Morgan Lewis & Bockius LLP in Chicago.

Most cryptocurrency owners buy them out of curiosity, interest or just because they think it could be a great investment. And it has been — so far. In that sense, it seems clear the asset should be considered personal property, which reduces the complexity so long as the owner's residence is clear. Cryptocurrency transactions would likely produce taxable income eventually for both the buyer and seller — either ordinary income or capital gains — which can be identified through the residence of both parties.

But cryptocurrencies aren't just a hobby anymore. They've become a thriving business. And that's where it gets a lot more complicated.

Many cryptocurrencies may seem closer to inventory than personal property, and different tax rules would apply. For those who earn a handsome living dealing in bitcoin, their inventory would likely be seen as part of a trade or business, and its location would be important for determining which rules apply, and how they apply.

“The tax ramifications are going to be different, based on whether the cryptocurrency constitutes traditional tangible personal property, or if it's classified as inventory,” said Patrick McCormick

of Drucker & Scaccetti in Philadelphia. “The inventory rules are going to get very complex.”

Around the world, entire farms of computer servers are busily humming as they mine bitcoins and other cryptocurrencies. How should the tax system treat the owners of those, who may hold onto those cryptocurrencies once they are realized or sell them immediately? The rules are blank.

“I don't know what you would point to, to give yourself comfort at night when it comes to a mining operation that is all over the world, including some connection with the U.S.,” Yates said.

Or suppose you're a software firm that has developed a new program that can assist miners in their calculations — and you've sold it to them, perhaps in exchange for the very cryptocurrency they're mining?

For that matter, not all cryptocurrencies are created to be used as currencies alone. Many are a form of investment — a venture will create an “initial coin offering” for financing, akin to a company raising money through a public offering. In that case, the cryptocurrency isn't just a valuable asset; it gives its owner an immediate and often recurring return. To source that income, the IRS may look at not only the nature of the asset itself but the operations it is connected to, which could be yet another complex calculation.

In May the Association of International Certified Professional Accountants sent a letter to the IRS outlining proposed FAQ guidance on cryptocurrencies. On foreign reporting, it asked the agency for guidance on when the rules apply, and also asked that the “wallet” — the registered company that runs the blockchain — not be considered the location of the asset.

The IRS has not yet issued guidance on foreign reporting for what it terms “convertible digital currencies.”

--Editing by Tim Ruel and John Oudens.