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Unique tax questions posed by cryptocurrencies and NFTs

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The basics of cryptocurrency taxation are simple: because crypto is treated as property for tax purposes, buying, selling, and (less obviously) trading and mining crypto have tax implications. However, crypto, and other property powered by blockchain technology like non-fungible tokens (NFTs), have unique characteristics that give rise to many unique tax questions. This article explores some of those questions and discusses what taxpayers can do in the face of uncertainty to protect themselves from the IRS's increasing scrutiny in this area.

Tax treatment generally

In 2014, the IRS published a Notice establishing the IRS's position that that "virtual currency" — a tax term of art that includes cryptocurrency — is treated as property for federal income tax purposes.[1] As a result, longstanding tax principles applicable to property transactions apply to virtual currency.

In 2019, the IRS issued Frequently Asked Questions on Virtual Currency Transactions,[2] which reiterates that virtual currency is treated as property for federal income tax purposes and provides numerous examples applying longstanding tax principles to common (and uncommon) virtual currency transactions.

The FAQs also answer some questions unique to virtual currency, like how to value virtual currency received in a peer-to-peer transaction (i.e., a transaction not involving a crypto exchange) or the tax treatment of a "soft fork," which is a type of software change resulting in no new cryptocurrency. While the IRS has updated these FAQs on a few occasions, the FAQs have largely remained static since their original issuance and are not known for covering new and developing issues.

The IRS has also issued *ad hoc* guidance to address certain specific questions unique to virtual currency. For example, the IRS issued guidance to address the tax treatment of "hard forks," in which a change to the software of cryptocurrency creates two or more separate versions of the blockchain.[3] In addition, the IRS issued guidance to address the tax treatment of pre-2018 like-kind exchanges of Bitcoin, Litecoin, and Ether.[4]

There is no uniform or comprehensive guidance on the taxation of virtual currency, and to date the guidance is largely administrative. This has left large unresolved tax questions regarding the taxation of virtual currency, despite the repeated requests for more guidance to the IRS from the tax community. Furthermore, there is no guidance on the tax treatment of NFTs, which raise their own unique tax questions.

Unique tax questions on crypto and NFT taxation

Crypto and NFTs have unique characteristics, both in terms of their status as a digital item and how they are traded, that can make the tax treatment unclear. Below we identify and address some of the common issues encountered when dealing with crypto or NFTs.

Exchanging crypto-for-crypto (or crypto-for-NTF)

Selling crypto for cash is a common and the most obvious taxable event. For example, if you buy 1 Bitcoin (BTC) for $38,000 on March 8, 2022, and sell it for $48,000 on March 29, 2022, you have $10,000 of taxable short-term capital gain.

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Exchanging crypto for another type of crypto or NFT is also a common but far less obvious taxable event. For example, if you buy 1 Bitcoin (BTC) for $38,000 on March 8, 2022, and exchange it on March 29, 2022, for 15 Ether (ETH) with a fair market value of $48,000, you would still have $10,000 of taxable short-term capital gain because you exchanged property (BTC) for other property (ETH), which is a taxable exchange. Suppose then that your 15 ETH increases in value to $50,000, and you exchange your 15 ETH for an NFT. This exchange is also taxable and gives rise to $2,000 of additional short-term capital gain. Now imagine two months later you sell the NFT for 15 ETH — exactly what you paid for it — but the 15 ETH has increased in value to $54,000. This is also a taxable exchange, triggering an additional $4,000 of short-term capital gain. Note that these transactions generate $16,000 of total short-term capital gain — taxable at the short-term capital gains rate of up to 37% plus 3.8% Medicare tax on investment income — without actually generating any cash to pay the resulting tax liability.

Exchanges occurring after December 31, 2017, are explicitly ineligible for like-kind exchange treatment because of the Tax Cuts and Jobs Act of 2017, which amended I.R.C. § 1031 to apply only to like-kind exchanges of real property. But even for exchanges occurring on or before December 31, 2017, the IRS has taken the position that — at least with respect to exchanges of Bitcoin, Ether, and Litecoin — such exchanges are not of "like kind" and therefore ineligible for tax-deferral under I.R.C. § 1031.

Wash sale rules

Cryptocurrency is not currently subject to the "wash sale" rules because cryptocurrency is not "stock" or "securities" within the meaning of under I.R.C. § 1091. This is a loophole for now, where a taxpayer can sell its crypto to harvest losses and (unlike stock) buy it right back. Congress and the IRS are aware of this issue — indeed, Congress proposed to fix it in the Build Back Better Act, which did not become law — and they may try again to change the law, possibly with retroactive effect.

While the sale and immediate repurchase of cryptocurrency is not a "wash sale," the IRS may rely on general tax principles, like "economic substance" or the "sham transaction" doctrine, to disallow loss on the sale.

In *Horne v. Commissioner*, 5 TC 250 (1945), for example, the Tax Court ruled that, while a sale and repurchase of a membership certificate in a company was not a "wash sale," the loss was disallowed because the sale and repurchase were separated by only eight days and so the taxpayer did not suffer a loss and instead "stood in exactly the same position as before."

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There is no hard and fast rule for avoiding recharacterization by the IRS — the more time between the sale and repurchase, the better. As an alternative strategy, a taxpayer can exchange its crypto for another crypto for which the price is closely correlated and wait 30 days before exchanging back to the first crypto. In this way, the taxpayer complies with the wash sale rules without missing out on any price rebound.

However, this also raises interesting considerations because many cryptocurrencies are pegged to other crypto. This means a taxpayer could essentially accomplish what would otherwise be considered a wash sale with two cryptocurrencies that are pegged to the same crypto. It is unclear how far the IRS would press general tax principles to disallow losses from such a transaction or whether the courts would agree with such a challenge.

NFTs as 'collectibles'

An open tax issue is whether NFTs in the form of digital artwork (like Beeple's "Everydays — The First 5000 Days") or digital trading cards (like the NBA Top Shot Moments) are treated as "collectibles" for tax purposes. Collectibles are subject to unfavorable tax treatment, including a 28% long-term capital gains rate versus a 20% maximum long-term capital gains rate on other capital assets if held more than a year.

"Collectibles" are defined to include "any work of art," among other items of "tangible personal property" listed in I.R.C. § 408(m). The IRS has traditionally included sports trading cards as collectibles, given their similarity to artwork.

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While the IRS might conclude that NFT artwork, or the NBA Top Shot Moments, are "works of art" like their physical counterparts, it is less obvious whether these NFTs are "tangible personal property" within the meaning of I.R.C. § 408(m). Whether digital items are tangible or intangible is a highly debated topic and often turns on specific facts and circumstances. While an NFT seems quintessentially intangible — it exists as only a string of numbers and letters and has no physical form — other digital items, like software for example, have been held to be tangible under certain circumstances.

Donating crypto and NFTs

As set out in the FAQs, taxpayers can donate virtual currency to a 501(c)(3) organization without recognizing gain or loss and may be eligible for a charitable contribution deduction generally equal to the fair market value of the donated virtual currency, provided the taxpayer has held the donated virtual currency for more than one year as a capital asset.

Donating virtual currency raises some open tax questions not addressed by the FAQs. For example, when a donor claims a charitable contribution deduction in excess of $5,000 for donated virtual currency (and therefore must substantiate the deduction with a "qualified appraisal"), it is unclear which appraisers have the requisite education and expertise to appraise the donated virtual currency, especially with respect to new and emerging virtual currencies. The IRS can (and frequently does) disallow large charitable contribution deductions for noncompliance with technical substantiation requirements, so donors are encouraged to seek advice to ensure they are in compliance with such requirements.

Gift tax issues

All lifetime estate planning techniques are available when dealing with virtual currency. Therefore, all traditional methods of making a gift of virtual currency are available, whether that is outright gifts (annual exclusion or otherwise), irrevocable trusts (grantor trusts and non-grantor trusts), grantor retained annuity trusts, family limited partnerships, or charitable giving.

Before planning with virtual currency, estate planners and clients should be mindful of the client's basis in the virtual currency. Because virtual currency is treated as property for federal income tax purposes, everyone has basis in her or his virtual currency holdings. When a gift of virtual currency is made, the donee generally will receive the donor's basis, or so-called carry-over basis, in the given virtual currency.

The similarities between virtual currency and the U.S. dollar or a foreign currency are hard to deny, and this puts pressure on Congress and the IRS to regulate virtual currency like real currency under certain circumstances.

Relatedly, if the donor decides to retain that virtual currency until her or his death instead of giving it away, the virtual currency would receive a new basis equal to the fair market value of the virtual currency as of the donor's date of death. Thus, a careful analysis comparing the potential value-shifting benefit of a gift versus the income tax savings from potentially stepped-up basis at death must be entered into the by the client and the client's advisors.

Due to the extreme fluctuations in value of virtual currency, making gifts of virtual currency can lead to an easy homerun or a waste of lifetime exemption. For this reason, grantor retained annuity trusts (GRATs) are very attractive vehicles for planning with virtual currency. GRATs can capture short term swings in value with the use of little to no lifetime exemption. If GRATs are utilized, a separate GRAT should be formed for each type of virtual currency. This will maximize the value of the remainder interest for each of the GRATs, which will pass to children or trusts held for the benefit of the donor's descendants.

The volatility of virtual currency can also be helpful in the family limited partnership context. In *Holman v. Commissioner*, the Tax Court held that the volatility of Dell stock was a significant factor in rejecting the IRS argument that the gift of a limited partnership interest six days after the formation of the partnership was an indirect gift of the Dell stock that was contributed to the partnership (i.e., without a discount).[5] The Tax Court suggested that more time may be needed if non-volatile assets such as preferred stock or bonds comprised the majority of the contributed property. Perhaps less time will be needed between the formation of the partnership and a gift of a limited partnership interest if the underlying assets of the partnership are comprised of virtual currency, which could avoid an indirect gift argument from the IRS and sustain the taxpayer's valuation of the given limited partnership interest.

Virtual currency v. real currency

The IRS treats virtual currency as property (and not currency) for federal income tax purposes. Nevertheless, the similarities between virtual currency and the U.S. dollar or a foreign currency ("*real currency*") are hard to deny — both function as a unit of account, a store of value, and a medium of exchange — and this puts pressure on Congress and the IRS to regulate virtual currency like real currency under certain circumstances. Congress has already taken steps in this regard. Under the Infrastructure Investment and Jobs Act (the "*Infrastructure Act*") signed on November 15, 2021, businesses that receive digital assets with a fair market value of more than $10,000 are required to report such transactions to the IRS, which aligns with existing reporting obligations on Form 8300 for cash transactions.

This virtual currency v. real currency distinction is only becoming more difficult to maintain as virtual currency becomes more prevalent and accepted worldwide. For example, El Salvador recognized Bitcoin as its national currency in September 2021, which raises several international tax issues, including for example whether the tax rules regarding foreign currency gain or loss should apply (notwithstanding Notice 2014-21's general statements to the contrary).[6]

Third-party reporting

In the Infrastructure Act, Congress expanded the definition of the term "broker" to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person" and requires brokers to submit Form 1099-Bs to investors and the IRS.

The definition of broker is broad enough that there is a concern that it could be interpreted as including miners and other participants in the digital asset economy who may not be commonly understood to be "brokers." While Senators Wyden and Lummis have introduced a bill that seeks to narrow the definition of "broker," and Treasury is expected to issue similar guidance,[7] taxpayers should seek advice to ensure they are in compliance.

IRS enforcement

While crypto owners are taking steps to make it difficult to track themselves — there has been a proliferation of off-chain transactions that make it difficult or impossible to trace ownership of crypto as well as anonymizing tools such as tumblers that are being used — crypto owners may nevertheless find it difficult to remain anonymous from the IRS, particularly when they eventually convert their crypto to cash, which tends to require personal identification at the time of the exchange.

The IRS has stated it is increasing enforcement with respect to unreported crypto transactions. It has worked with outside vendors to develop advanced tracking tools, and is coupling those tools with the results of its "John Doe" summons efforts to put names on wallets that would not otherwise be trackable. The IRS has stated it will be issuing tens of thousands (or more) warning letters to taxpayers it knows have not reported crypto transactions as well as commencing civil and criminal audits against taxpayers with more egregious fact patterns.

U.S. taxpayers who have held any virtual currency should be mindful of the increased IRS scrutiny in this area. With limited IRS guidance on virtual currency available, taxpayers should establish a clear reporting plan as soon as possible.

Notes

[1] IRS Notice 2014-21.

[2] https://bit.ly/3jqeJU3

[3] IRS ILM 202114020 (released Apr. 9, 2021) and Rev. Rul. 2019-24.

[4] IRS ILM 202124008 (released June 18, 2021).

[5] *Holman v. Comm'r*, 130 T.C. 170, 189–91 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

[6] *See* I.R.C. § 988.

[7] *See* RIN: 1545-BP71, https://bit.ly/3M1QdFf

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