

**CALIFORNIA LAWYERS ASSOCIATION
TAXATION SECTION
2022 WASHINGTON D.C. DELEGATION**

**A CREATIVE CRITIQUE OF THE CURRENT
CRYPTIC RULES FOR TAXING CRYPTO**

This proposal was written by James Creech, Dennis Leonard, and Justin Miller.^{1,2,3} The authors wish to thank the members of the California Lawyers Association Taxation Section Executive Committee whose exceptional efforts allow for this opportunity.

Contact Information:

James Creech
Baker Tilly
50 Fremont Street, Suite 4000
San Francisco, CA 94105
(415) 291-2454
james.creech@bakertilly.com

Dennis Leonard
Ramsbacher Prokey Leonard LLP
111 W. St. John Street, Suite 1200
San Jose, CA 95113
(408) 293-3616
dil@rpllawfirm.com

Justin Miller
Evercore Wealth Management
425 California Street, Suite 1500
San Francisco, CA 94104
(415) 288-3012
justin.miller@evercore.com

¹ The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association.

² Although the authors and presenters of this paper may have clients affected by the rules applicable to the subject matter of this paper and may have advised such clients on applicable law, such participants have not been engaged by a client to participate on this paper.

³ James Creech is a Senior Manager at Baker Tilly. Dennis Leonard is a Partner at Ramsbacher Prokey Leonard LLP and a Fellow of The American College of Trust and Estate Counsel (ACTEC). Justin Miller is a Partner and National Director of Wealth Planning at Evercore Wealth Management, an adjunct professor at Golden Gate University School of Law, and an ACTEC Fellow. The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice. The reader should contact his or her legal or tax advisor prior to taking any action based on this information.

EXECUTIVE SUMMARY

The Internal Revenue Service (“IRS”) and Department of Treasury (“Treasury”) have issued limited guidance related to virtual currency. Despite the exponential increase of virtual currency utilization in recent years, there has been relatively little official guidance since 2019.⁴ Since then, the technology that underlies virtual currency has evolved and tested the limits of how the existing guidance can be applied.

The sparse and evolving nature of formal guidance for virtual currency users has created a vacuum in which misinformation and potential taxpayer non-compliance are rampant. In order to encourage and improve voluntary taxpayer compliance, the IRS and Treasury should: (1) implement a new voluntary disclosure program for crypto assets to allow non-compliant taxpayers to become compliant with reduced penalties; (2) encourage taxpayers to seek IRS approval on virtual currency transactions via private letter ruling (“PLR”) procedures; and (3) offer more informal guidance—such as frequently asked questions (“FAQs”)—while providing penalty protection for those taxpayers who are attempting to comply with their tax obligations. These programs would have the benefit of encouraging taxpayers who are involved in virtual currency transactions to come forward and engage with the IRS and further the exchange of information.

A new Crypto Voluntary Disclosure Program (“CVDP”) for virtual assets could be modeled on the Offshore Voluntary Disclosure Program (“OVDP”) or the Streamlined Filing Compliance Procedures program (“Streamlined Procedures”) that were used for foreign financial asset reporting compliance. CVDP would: (i) help the government collect additional revenue; (ii) allow non-compliant taxpayers to come into compliance without the risk of a future IRS summons or audit; and (iii) raise the cost of non-compliance for taxpayers who choose not to enter the program.

Encouraging virtual currency PLRs would allow the IRS to learn more about virtual currency transactions, engage in dialogue with taxpayers about the details of such transactions, and provide guidance in a setting that would not bind the IRS in the same manner as issuing Revenue Rulings. Furthermore, encouraging virtual currency PLRs would provide virtual currency users a safe and relatively anonymous method to address any number of yet-uncertain subjects involving income tax, estate/gift tax, valuation, and permissible accounting methods.

Enhancing the ability of taxpayers to rely on IRS communications such as FAQs would help build trust between the IRS and virtual currency users. Currently,

⁴ Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (Oct. 19, 2019).

taxpayers cannot rely on an IRS FAQ qualifying as substantial authority for purposes of penalty relief or take comfort that it could change without notice. Despite a press release in October 2021 expressing the IRS's intentions to make such changes, the lack of substantial authority for virtual currency users may cause many taxpayers not to report transactions rather than report and risk penalties.⁵ Permitting reliance on IRS FAQs would increase virtual currency communications, reduce risk of penalties for reliance on such communications, and further enhance voluntary compliance.

⁵ IRS IR 2021-202 (Oct. 15, 2021).

DISCUSSION

I. BACKGROUND

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and a store of value.⁶ While the terms virtual currency and cryptocurrency are often used interchangeably, cryptocurrency technically is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger. Distributed ledger technology—such as blockchain—uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality.⁷

For federal income tax purposes, virtual currency is treated as property—not currency.⁸ While units of virtual currency are generally referred to as coins or tokens, virtual currency is not recognized by the U.S. government as a representation of United States currency or a “foreign currency.” To qualify as a foreign currency under U.S. law, the asset would need to be coin or paper money of a country other than the United States that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance.⁹ In other words, virtual currency is a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency.¹⁰

Determining how to tax virtual currency transactions is a continually evolving process. Virtual currencies are often bought and sold in exchange for other virtual currencies or for U.S. or foreign currencies. New virtual currency also could be obtained by technological processes such as mining, staking, hard forks, or air drops—all of which are new concepts that do not traditionally apply to U.S. or foreign currencies. Given that virtual currency is a relatively new phenomenon, there are still a multitude of unanswered questions of how various transactions should be treated for federal income, gift, estate, and generation-skipping transfer tax purposes.

II. VOLUNTARY COMPLIANCE PROGRAM

Given all the recent technological developments related to virtual currency and the understandably sparse and evolving guidance regarding the tax treatment of virtual currency, a newly created CVDP would encourage improved tax compliance. Such a program would almost certainly lead to an increase in government revenue by encouraging non-compliant taxpayers to come into compliance. For those non-compliant taxpayers who do not voluntarily participate in the program, the government could raise the cost of non-compliance if later discovered via summons or audit. Thus, a voluntary program would provide an avenue for taxpayers who wish to

⁶ Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (Oct. 19, 2019).

⁷ Id.

⁸ IRS Notice 2014-21, 2014-16 I.R.B. 938 (Mar. 25, 2014).

⁹ 31 C.F.R. § 1010.100(m). Notwithstanding the forgoing, both El Salvador and the Central African Republic are foreign countries that have adopted Bitcoin as “legal tender”, on September 7, 2021 and April 27, 2022, respectively.

¹⁰ FinCen FIN-2013-G001. It should be noted that El Salvador gave Bitcoin legal tender status in September 2021—to aid transfers of funds from people outside of the country to residents, assist residents who lack access to financial accounts, and promote investment. Joe Hernandez, “El Salvador Just Became The First Country to Accept Bitcoin As Legal Tender,” NPR, Sept. 7, 2021; <https://www.npr.org/2021/09/07/1034838909/bitcoin-el-salvador-legal-tender-official-currency-cryptocurrency>

avoid the potential threat of additional civil and criminal penalties related to virtual currency transactions.

CVDP could be modeled on OVDP or Streamlined Procedures. The IRS initiated OVDP in March 2009 as a voluntary disclosure program specifically designed for taxpayers with exposure to potential criminal liability and/or substantial civil penalties due to a willful failure to report foreign financial assets and pay all tax due in respect of those assets. OVDP was designed to provide taxpayers with such exposure: (1) protection from criminal liability; and (2) terms for resolving their civil tax and penalty obligations.¹¹ The 2009 version of OVDP was so successful, that the IRS announced an additional 2011 Offshore Voluntary Disclosure Initiative (OVDI) in February 2011, which lasted until Sep. 9 2011.¹² Based on the success of both the 2009 and 2011 programs, the IRS offered a revised version of the program in a 2012 OVDP, which was modified again in 2014 and then closed in 2018.¹³ Since the OVDP's initial launch in 2009, more than 56,000 taxpayers have used one of the programs to comply voluntarily, and those taxpayers paid a total of \$11.1 billion in back taxes, interest, and penalties.¹⁴

As a separate program from OVDP, Streamlined Procedures were made available to taxpayers certifying that their failure to report foreign financial assets and pay all tax due in respect of those assets did not result from willful conduct on their part. Streamlined Procedures were designed for taxpayers who might not have been aware of their filing obligations, and have helped about 65,000 additional taxpayers come into compliance.¹⁵

Similar to OVDP and Streamlined Procedures for foreign financial assets, a voluntary disclosure program for virtual currency transactions could be implemented to encourage better compliance. Rather than risking potentially significant civil and criminal penalties in the future, CVDP would motivate taxpayers by offering reduced penalties to voluntarily report their past virtual currency transactions—many of which may have taken place prior to any applicable tax guidance being issued by the federal government.

As an example, Adam exchanged \$1 million in Bitcoin for Ether on January 1, 2017.¹⁶ At the time, it was reasonable to believe that the transaction would qualify as a tax-deferred like-kind exchange under Section 1031.¹⁷ The transaction occurred before 2018, which is when tax-deferred like-kind exchanges under Section 1031 for property other than real estate were eliminated by the Tax Cuts and Jobs Act of 2017 (“TCJA”). Adam’s 2017 tax return was due on April 15, 2018, but he claimed an automatic extension to file on October 15, 2018. On June 8,

¹¹ IRS FS 2014-6 (Jun. 2014) (It offered taxpayers an opportunity to avoid criminal prosecution and a settlement of a variety of civil and criminal penalties in the form of single miscellaneous offshore penalty. It was based on existing voluntary disclosure practices used by IRS Criminal Investigation.).

¹² IRS FS 2014-6 (Jun. 2014) (In the 2009 OVDP the IRS received 15,000 disclosures prior to the Oct. 15 closing date that year. It resulted in the collection of \$3.4 billion in back taxes, interest and penalties. It also led to another 3,000 disclosures after the closing date.)

¹³ IRS IR 2018-52 (Mar. 13, 2018).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Unless otherwise provided, the names, characters, businesses, places, and events discussed in the hypothetical examples in this paper are fictitious. Any resemblance to actual persons, living or dead, or actual events is purely coincidental.

¹⁷ All tax code section references are to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise noted.

2021—more than four years after Adam’s virtual currency exchange—the IRS released IRS Legal Memo 202124008 that found an exchange of (i) Bitcoin for Ether, (ii) Bitcoin for Litecoin, or (iii) Ether for Litecoin did not qualify as tax-deferred like-kind exchange under Section 1031.¹⁸ Even though the IRS guidance was not released until 2021, a six-year statute of limitations could apply to Adam’s 2018 return, which would allow the IRS the ability to go back and audit his return until 2024. If Adam had not filed a return, the statute of limitations would remain open indefinitely. Since a voluntary compliance program such as CVDP is not currently available for virtual currency, Adam does not have additional financial motivation to amend his returns and comply with the belated IRS guidance. Without such a program for reduced penalties, Adam may be more inclined to play the so-called “audit lottery” and hope that the IRS does not find out about his undisclosed virtual currency transactions prior to the expiration of the statute of limitations in 2024.

III. PRIVATE LETTER RULINGS

The first step in crafting useful guidance that balances the needs of both taxpayers and the government is an understanding of how the particular industry operates in the real world—as opposed to just in theory. One of the challenges for tax practitioners, regardless of whether they work in the private sector or in government, is that virtual currency is a novel creation that evolves at a rapid rate.

While there is a significant amount of information available through internet research, many of the sources of the information are anonymous posts on message boards or social media that may not be reliable. While practitioners in private practice have clients who may explain the technical side of transactions to them, the government does not necessarily have the same luxury.

One way that the government may be able to bridge this knowledge gap between industry and private sector is by encouraging taxpayers to come forward and request PLRs for transactions involving virtual currency. PLRs are an ideal method for the drafters of broader guidance to learn more about the nuts and bolts of virtual currency transactions, establish dialogue with taxpayers about the non-tax motivations for a particular transaction, and to encourage full disclosure of all relevant facts.

Virtual currency PLRs would further provide an opportunity for the IRS to offer incremental guidance on developing issues in a timely manner. In the virtual currency area, timeliness is especially important because guidance becomes stale quickly. It is much easier for the IRS from a practical perspective to apply existing law to a specific fact pattern in a PLR, as opposed to creating an entire new set of general rules to address a wider range of potential fact patterns to be published as official guidance in the Internal Revenue Bulletin.

Limited reliance—both in terms of the specific mechanics of the transaction as well as the fact that the only taxpayer who can rely on the PLR is the taxpayer who requested it—means that the IRS should feel more comfortable providing direct application of the existing law to specific virtual currency transactions, rather than having to craft new general rules intended for all virtual

¹⁸ IRS Legal Memo (ILM) 202124008.

currency users. Ideally, this would mean more frequent virtual currency PLRs on a wider range of topics rather than waiting for broader and more infrequent statutory or regulatory guidance.

Taxpayers also would benefit from an expanded invitation to submit virtual currency PLRs. Given the tremendous amount of uncertainty about the taxation of virtual currency, it would be helpful for taxpayers with high-dollar transactions to be able to obtain certainty on specific issues. For example, in keeping with the Section 1031 like-kind exchange example above, the taxpayer who is now seeking to enter the proposed voluntary compliance program might have been able to request a PLR as to the applicability of an exchange to determine whether tax was due. A PLR could have provided guidance that Section 1031 treatment was not available pre-TCJA, which could have prevented the taxpayer's non-compliance as well as the associated cost of non-compliance both for the taxpayer and the government.

More practically, many virtual currency users prioritize their anonymity for any number of reasons, including fear of hacking, identity theft, and even kidnapping. The inherent privacy of a PLR affords taxpayers a ready method to seek specific answers to open questions in a way that both preserves the taxpayer's anonymity while still providing helpful—albeit non-binding—guidance to other virtual currency users.

Some of the current issues that potentially could be subject to a PLR request include, but are not limited to:

- Staking Rewards: For example, taxpayers who “stake” Ethereum 2.0 (i.e., individuals who validate transactions and offer their own tokens as collateral in order to incentivize accuracy) might receive a 5-6 percent interest-like reward for their “staking” activity in the form of additional Ethereum 2.0 tokens. However, that brand of virtual currency is not yet released—and may never be. Moreover, the failure to properly validate transactions can result in the forfeiture of the tokens the individual “staked” as collateral. Such staking transactions have uncertain income tax consequences.
- Retained Interests for Transfer Tax Planning Purposes: Lifetime transfers of assets are subject to potential estate tax inclusion in connection with retaining improper economic rights (e.g., Section 2036 inclusion) or undue control (e.g., Section 2038). Virtual currency is a unique, decentralized asset where concepts of “ownership” and “control” are inextricably linked to knowledge of passwords and recovery or “seed” phrases, rather than title or possession. Traditional planning methods—even simple lifetime gifts—have not yet been exposed to such generally applicable rules with transfers of virtual currency. Of particular concern is how to safely and legally affect transfer tax planning when the transferor cannot “unknow” the passwords or seed phrases connected to the virtual currency being transferred.
- Losses Under Section 165: It is not uncommon for virtual currency to permanently lose value in connection with hacking, lost passwords, defunct exchanges (e.g., Mt. Gox), failure to attain widespread adoption, and other risks. Certain qualities unique to virtual currency losses seem to lend themselves to Section 165 applicability, but there does not yet appear to be any authority directly on point.

- Additional Unique Challenges: Other items that might lend themselves to PLRs include unique challenges in connection with changes in accounting methods, the treatment of virtual currency lending, and the character of non-fungible tokens.

While perhaps beyond the scope of a PLR, the subject of virtual currency valuation is another area where there is a dearth of guidance and authority for income, estate, and gift tax purposes. Somewhat recent guidance in the “hard fork” context suggests using “any reasonable method.”¹⁹ However, it is unclear if this would be sufficient to satisfy the “adequate disclosure” rules in connection with federal gift tax returns.²⁰ Because virtual currency is not a “stock or bond,” government guidance is necessary for taxpayers to determine whether they can or cannot use the safe harbor of averaging the high and low quoted selling price on an over-the-counter or public exchange.²¹ Moreover, the value of even widely-recognized virtual currencies can differ from one exchange to the next—for example, Coinbase versus Kraken. Prices also can be subject to extreme volatility even on the same day, which raises the question of whether the actual time of day may matter. Lastly, significant amounts of virtual currency are privately held in “vaults” or “cold wallets” that are not tied to a public exchange, which makes it even more perplexing to value.

A related issue involves the valuation of interests in legal entities, which sometimes requires valuation adjustments (e.g., discounts for lack of control, discounts lack of marketability, discounts for “blockage,” “premiums” for control, etc.). Many leading cases and authorities consider the nature of the assets within the entity. For example, entities holding cash typically receive much more modest valuation adjustments than entities holding undeveloped real estate. Guidance is especially needed with respect to the valuation of legal entities holding virtual currency. Many qualities unique to virtual currency involve extreme volatility, the risk of new legislation, the risk of loss/hacking/lost passwords, mounting environmental considerations, and the provenance of virtual currency (e.g., the risk of seizure of virtually currency previously held by bad actors). Both the IRS and taxpayers will be working through these considerations—and more—as the subject of valuing these novel assets continues to develop.

A mere solicitation for expanded use of PLRs addressing virtual currency would not eliminate the IRS’s ability to turn down a PLR request because the Service chooses not to weigh in on a particular subject. The goal simply would be to inform taxpayers and practitioners that the IRS is open to receiving requests and that there are options beyond simply waiting for case law or other such guidance before the virtual currency community can obtain certainty on discrete issues.

In this regard, there is currently only one virtual currency question where the IRS has stated it will not issue PLRs—namely exchanges of one virtual currency for a contractual obligation requiring the return of identical virtual currency or the transfer of identical virtual currency in satisfaction of the contractual obligation.²² Accordingly, there seems to be something of an open field with which taxpayers might utilize PLRs to address any number of other unsettled issues facing virtual currency. However, despite the substantial need for taxpayer guidance, there are relatively few PLRs or other administrative guidance addressing virtual currency issues. Thus,

¹⁹ IRS Legal Memo (ILM) 202114020.

²⁰ Treas. Reg. § 301.6501(c)-1.

²¹ Treas. Reg. § 20.2031-2(b).

²² Rev. Proc. 2022-3, Section 3.01(99), “Determination of Amount of and Recognition of Gain or Loss; Transfers of Securities Under Certain Agreements.—Whether a taxpayer recognizes gain or loss on the transfer of virtual currency in exchange for a contractual obligation that requires the return of identical virtual currency to the taxpayer or on the transfer of identical virtual currency to the taxpayer in satisfaction of the contractual obligation.”

PLRs offer a potentially fruitful source of engagement between taxpayers and the IRS on the many evolving topics surrounding virtual currency.

IV. IRS FAQs

Frequently asked questions (“FAQs”) are a valuable alternative to official guidance published in the Internal Revenue Bulletin because they allow the IRS to communicate information more quickly to taxpayers on topics of frequent inquiry and general applicability—such as virtual currency. However, many taxpayers are unaware that FAQs are considered communication—not guidance.²³ In other words, taxpayers could follow the FAQs, the IRS could change its mind in the future, and the taxpayer still could be subject to certain penalties.

Fortunately, on October 15, 2021, the IRS released a statement (the “October 15 Statement”) on the use of FAQs for newly enacted tax legislation that was a positive step forward in matching taxpayer expectations to rely on FAQs for penalty protection compared to how FAQs historically have been used by the IRS.²⁴ The October 15 Statement added that FAQs published in a “Fact Sheet” that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return.²⁵

This new ability for FAQs to act as a bridge between official guidance published in the Internal Revenue Bulletin and a relatively quick form of IRS communication makes the Fact Sheet ideal for issuing virtual currency guidance. The Fact Sheet provides a means for the IRS to issue robust virtual currency FAQs posted on the IRS.gov website while allowing taxpayers to rely on those FAQs without having to worry about whether the FAQ was valid for penalty purposes. In addition, including virtual currency FAQs in the retention program discussed in the October 15 Statement would allow for interested taxpayers and their advisors to review prior FAQs to see the evolution of the language the IRS has chosen in the description of transactions and the impact certain events have had on the guidance over time.

Thus, including virtual currency FAQs as part of the new IRS Fact Sheet process—together with the incentive for penalty protection for following such FAQs—would encourage improved taxpayer voluntary compliance. It also would help counter some of the popular—but mistaken—beliefs related to the taxation of virtual currency that are often shared via social media.

V. CONCLUSION

Voluntary compliance involving virtual currency can be extremely challenging for taxpayers at the cutting edge of the technology. There are numerous grey areas of the law, and taxpayers are often forced to make critical decisions about the character of gains and losses with relatively little government guidance. If those decisions eventually turn out to be incorrect based on guidance provided in later years, there is no easy way for taxpayers to correct those mistakes. However, there are several small steps the IRS and Treasury can undertake to reduce the burden

²³ “FAQs that have not been published in the Bulletin will not be relied on, used or cited as precedents by Service personnel in the disposition of cases. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Only guidance that is published in the Bulletin has precedential value.” IRS IR 2021-202 (Oct. 15, 2021).

²⁴ *Id.*

²⁵ Treas. Reg. § 1.6662-4(d).

of voluntarily compliance. Creating a mechanism for taxpayers to voluntarily correct past non-compliance with reduced penalties, opening channels via the PLR method directly with the drafters of the guidance, and clearer communication through FAQs would all be welcome solutions from the IRS and Treasury to make it easier for taxpayers with virtual currency to do the right thing.