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PROPOSED CHANGES TO THE TAX TREATMENT OF LOSSES INCURRED BY TAXPAYERS WHO INVEST IN CRYPTOCURRENCY, VIRTUAL CURRENCY, AND OTHER DIGITAL ASSETS UNDER IRC SECTION 165 (Treas. Reg. §§ 1.165-1, 1.165-5, 1.165-8)

This proposal was prepared by Charles J. Taylor.[1] The author thanks reviewers Annette Nellen, Julie Treppa, and Joseph P. Wilson.[2] [3]

Contact Person: Charles J. Taylor, JD, LL.M.

California State Controller's Office
888 South Figueroa Street, Suite 2050
Los Angeles, CA 90017
(213) 833-6033
cxtaylor@sco.ca.gov

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EXECUTIVE SUMMARY

Last year, there were four notable crypto currency bankruptcies: (i) Celsius Network, (ii) Three Arrows Capital, (iii) Voyager Digital, and (iv) FTX and FTX.US.[4] The primary reasons for the cryptocurrency losses were because (i) the digital assets the customers' held in their accounts abruptly and significantly dropped in value as a result of events that precipitated the bankruptcy or (ii) the customers' custodially held assets disappeared through misappropriation, hacking of the platform, or were simply unaccounted for.[5] It is not known whether customers of bankrupt cryptocurrency entities will ever see their money again. And, under current rules, it is not known when (or if) these investors will ever be able to claim a tax loss deduction as a result of the losses suffered from their cryptocurrency investments. This proposal makes it possible for cryptocurrency investors who suffered losses from investments in a failed digital currency exchange to claim tax loss deductions immediately.[6]

This proposal encourages the IRS to allow a well-defined and specific set of taxpayers who suffered investment losses from cryptocurrency to claim losses immediately, in accordance with the rules established in Revenue Ruling 2009-9 for Ponzi schemes. More specifically, taxpayers who initiated investments in digital currency through a cryptocurrency exchange and suffered losses from a Ponzi type scheme would, under this proposal, have the ability to claim immediate tax loss deductions on their 2022 and/or 2023 tax returns.

Regulators and prosecutors are still in the early stages of investigations related to the cryptocurrency exchanges and their related entities that failed last year (in 2022). Even though it's unlikely many cryptocurrency investors will recoup their lost investments, it may be sometime before these investors will have the ability to claim a tax deduction for their investment losses until ongoing criminal and civil inquiries conclude. For example, how should the IRS characterize losses incurred by victims of the failed cryptocurrency exchange FTX.us, and its related entities, where customers' custodially held assets disappeared through misappropriation, hacking of the platform, or were simply unaccounted for? The character of an investor's loss related to fraudulent activity depends, in part, on the nature and type of the investment. Under this proposal, a limited set of taxpayers who fit a defined set of criteria and fall within a specific set of facts, would be allowed to use a uniform and simplified method to determine the timing, character, and maximum available deduction for their cryptocurrency losses.

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[4] *Can I Deduct Crypotcurrency Losses*, Mondaq (1 December 2022), https://www.mondaq.com/unitedstates/tax-authorities/1256330/can-i-deduct-cryptocurrency-losses.

[5] Id.

[6] As long as the losses were evidenced by closed and completed transactions and fixed by identifiable events during the tax year such as a sale, exchange, or condemnation. I.R.C. §165 (2023) and Treas. Reg. §1.165-1(2023).

DISCUSSION

I. GENERAL OVERVIEW OF CRYPTOCURRENCY TAX RULES

This paper proposes the Internal Revenue Service establish a uniform and simplified method to determine the timing, character, and allowable theft loss deduction for cryptocurrency investors who suffered investment losses as a result of the collapse of FTX and other cryptocurrency exchanges in 2022. In order to qualify for the theft loss deduction suggested here, digital currency investors must have incurred losses from investments initiated through a cryptocurrency exchange (such as FTX, FTX.us, or a similar type exchange) in or prior to 2023. And the losses must have been evidenced by closed and completed transactions, fixed by identifiable events, and sustained in or prior to the 2023 tax year.

It is not known whether customers of bankrupt cryptocurrency firms and exchanges will ever see their money again.[7] And, under current rules, it is not known when or if these investors will be able to claim tax loss deductions as a result of the losses suffered from cryptocurrency investments that disappeared through misappropriation, hacking of the platform, or were simply unaccounted for. These concerns, in large part, are the subject of this paper proposal.

Regulators and prosecutors are in the early stages of investigations related to cryptocurrency exchanges (such as FTX, FTX.us, and their related entities) that collapsed in 2022, and must determine whether the cryptocurrency losses were the result of criminally fraudulent investment arrangements. It's likely these investigations will take some time to resolve. Therefore, failure to adopt this proposal may prevent many cryptocurrency investors from claiming otherwise allowable tax loss deductions for years, until ongoing criminal and civil inquiries conclude. If the recommendations proposed in this paper are approved and implemented, losses deducted under this proposal would (i) only apply to a narrowly defined set of taxpayers and circumstances, and (ii) not be subject to the 10 percent of AGI floor for personal casualty and theft losses provided by Code sections 165(h)(2) and (h)(5).

A. General Tax Principles Applicable to Digital Currency

Cryptocurrency, also called virtual currency or digital currency, is basically a digital way to represent value.[8] Under current law, for federal tax purposes, virtual currency that has an equivalent value in real currency – such as Bitcoin - is treated like property.[9] General tax principles applicable to property transactions apply to transactions using virtual currency.[10] A taxpayer who provides goods or services and receives payment in virtual currency must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received.[11] For example, a taxpayer who successfully "mines" virtual currency has gross income equal to the fair market value of the virtual currency as of the date of

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[7] Miles Brooks, Are Crypto Losses on FTX and BlockFi a Tax Write Off?, CoinLedger (Accessed on April 26, 2023), Available at https://coinledger.io/blog/ftx-and-blockfi-crypto-losses-tax-write-offs.
[8] Internal Revenue Service Notice 2014-21.
[9] Id.
[10] *Id*.
[11] *Id*.

receipt.[12] However, the transfer of virtual currencies among the taxpayer's own wallets, accounts, or addresses is not a taxable event, even if the taxpayer receives an information return from an exchange or platform as a result of the transfer.[13]

B. Theft Loss Deductions Generally

The rules for tax loss deductions are found at Internal Revenue Code Section 165 and the Treasury Regulations issued thereunder, including Treasury Regulation §§ 1.165-1 (Losses), 1.165-4 (Decline in value of stock), 1.165-5 (Worthless securities), and 1.165-8 (Theft losses).

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise.[14] But the loss must be evidenced by a closed and completed transaction and fixed by an identifiable event during the tax year such as a sale, foreclosure, or condemnation.[15] A theft loss is not deductible under section 165(a) for the taxable year in which the theft occurs unless that is also the year in which the taxpayer discovers the loss. Only a bona fide loss is allowable.[16] Substance and not mere form governs in determining whether a loss is deductible.[17] Accordingly, a loss deduction may be disallowed for a transaction that lacks economic substance and is entered into solely for tax benefits.[18]

For individuals, § 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for profit, including theft losses. Under § 165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. And § 165(f) permits a deduction for capital losses only to the extent allowed by §§ 1211 and 1212.

For Federal income tax purposes, a "theft" is defined as the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred and it must have been done with criminal intent. "Theft" is a word of general and broad connotation, and includes the taking of money or property by the following means: (i) blackmail, (ii) burglary, (iii) embezzlement, (iv) kidnapping for ransom; (v) larceny, and (vi) robbery. A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. However, a taxpayer need not show a conviction for theft.[19]

It should be noted, the character of an investor's loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a taxpayer can't deduct as a theft loss the decline in market value of stock acquired on the open market for investment if the decline is caused by disclosure of accounting fraud or other illegal misconduct by the officers and directors of the

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[12] See the IRS Digital Assets Page available at: https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets
[13] *Id*.
[14] I.R.C. §165 and Treas. Reg. §1.165-1.
[15] I.R.C. § 165 and Treas. Reg. § 1.165-8.
[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] See I.R.S. Publication 547 (Casualties, Disasters, and Thefts), March 2, 2023.

corporation that issued the stock if the officers and directors did not have the specific intent to deprive the shareholder of money or property.[20]

C. Limitations on Theft Loss Deductions

Section 165(h) imposes two limitations on casualty loss deductions, including theft loss deductions, for property not connected with a trade or business or with a transaction entered into for profit. Section 165(h)(1) provides that a deduction for a loss described in § 165(c)(3) (including a theft) is allowable only to the extent that the amount exceeds $100 ($500 for taxable years beginning in 2009 only).

Section 165(h)(2) provides that if personal casualty losses for any taxable year (including theft losses) exceed personal casualty gains for the taxable year, the losses are allowed only to the extent of the sum of the gains, plus so much of the excess as exceeds ten percent of the individuals adjusted gross income.

Section 67(a) provides that miscellaneous itemized deductions may be deducted only to the extent the aggregate amount exceeds two percent of adjusted gross income. However, under § 67(b)(3), losses deductible under § 165(c)(2) or § 165(c)(3) are excepted from the definition of miscellaneous itemized deductions. The limitations imposed by § 165(h) only apply to theft loss deductions for property not connected with a trade or business or with a transaction entered into for profit. Therefore, for purposes of this proposal, the limitations provided by § 165(h) do not apply because this topic proposal applies only to transactions entered into for profit or to losses otherwise allowed by § 165(c)(3).

Section 68 provides an overall limit on itemized deductions based on a percentage of adjusted gross income or total itemized deductions. But under § 68(c)(3), losses deductible under § 165(c)(2) or § 165(c)(3) are excepted from the limits imposed by Section 68.

In order to fully comply with the provisions of Section 165, the author of this paper presumes taxpayers seeking the benefits of this proposal opened their cryptocurrency investment accounts with FTX or its related entities with the intent to make a profit. And, based on the relevant criminal indictments, the author further presumes taxpayers who lost their investments in FTX and similar entities, lost their investments due to theft.[21] Accordingly, these cryptocurrency investors' theft losses are deductible under § 165(c)(2) because they were transactions entered into for profit and deductible under § 165(c)(3) because they were theft losses. As such, these losses are not subject to the § 165(h) limitations.

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[20] Id.

[21] In its Press Release announcing the indictment against FTX Founder Samuel Bankman-Fried, U.S. Attorney Damian Williams said: "One month ago, FTX collapsed, causing billions of dollars in losses to its customers, lenders, and investors. . . As today's charges make clear, this was not a case of mismanagement or poor oversight, but of intentional fraud, plain and simple." Press Release, U.S. Department of Justice, United States Attorney Announces Charges Against FTX Founder Samuel Bankman-Fried (December 13, 2022) (Available at: https://www.justice.gov/usao-sdny/pr/united-states-attorney-announces-charges-against-ftx-founder-samuel-bankman-fried)

One more point, for tax years beginning in 2018 through 2025, the deduction for personal casualty and theft losses is limited to losses attributable to federally declared disasters.[22] A taxpayer may still claim personal casualty and theft losses not attributable to federally declared disasters to the extent of any personal casualty and theft gains during 2018 through 2025.[23] However, this limitation, as described in Section 165 (h)(2) and Section 165(h)(5), does not affect this proposal because this proposal only applies to transactions entered into for profit and that were the result of theft.[24]

D. Year of Theft Loss Deduction

Section 165(e) provides that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss. Under Treasury Regulation §§ 1.165-8(a)(2) and 1.165-1(d), however, if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether or not the reimbursement claim will be received, for example, by a settlement or other adjudication.

Here, cryptocurrency investors should be allowed to deduct the theft losses in 2022, the year the theft losses were discovered, provided that the loss is not covered by a claim for reimbursement or other recovery as to which the digital currency investor has a reasonable prospect for recovery. If investors are forced to wait until all ongoing criminal and civil inquiries into FTX and similar entities are resolved, these investors may be forced to wait years to claim otherwise allowable theft loss deductions.

E. Amount of Theft Loss Deduction

Section 1.165-8(c) provides that the amount deductible in the case of a theft loss is determined consistent with the manner provided in § 1.165-7 for determining the amount of a casualty loss, considering the fair market value of the property immediately after the theft to be zero. The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery.

For example, if a digital currency investor invested $100X in FTX, added $20X to their investment, and later withdrew $30X, the total amount of the theft loss would equal $90X.[25]

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[22] 26 U.S. Code § 165(h)(5)
[23] *Id*.
[24] See I.R.C. § 165(c)(2) and I.R.C. § 165(c)(3).
[25] Treas. Reg. § 1.165-7 (Casualty Losses)

II. IS CRYPTO CURRENCY A CAPITAL ASSET?

A capital asset is generally any property whether or not connected with a trade or business.[26] A taxpayer must generally recognize gain or loss from the sale or exchange of property.[27] The seller has gain if the amount realized is more than the seller's adjusted basis in the property. The seller has a loss when the adjusted basis of the property is more than the amount realized.[28] For example, virtual currency is a capital asset that generates a capital gain or loss when it is sold or exchanged. The character of gain or loss from an exchange of virtual currency for property depends on the character of the currency in the taxpayer's hands. Thus, the gain or loss is capital if the virtual currency is a capital asset in the taxpayer's hands. Otherwise, the gain or loss is ordinary.[29]

Generally, property, including virtual currency, held for personal use, pleasure, or investment is a capital asset. Other examples of capital assets include: (i) stocks and bonds, (ii) a home owned and occupied by a taxpayer and his or her family, (iii) household furnishings, (iv) a car purchased for pleasure or commuting, (v) coin or stamp collections, (vi) gems and jewelry, and (vii) gold, silver, and other metals. Gain from a sale or exchange of a capital asset (or property of this type) is a capital gain. Loss from the sale or exchange of property held for personal use is not deductible.

III. THEFT LOSSES FROM PONZI-TYPE SCHEMES

Under current IRS rules, investors who incur losses from criminally fraudulent investment arrangements, such as "Ponzi" schemes, are entitled to claim a theft loss, rather than a capital loss, under section 165.[30] The loss is deductible as a loss on a transaction entered into for profit, and is not subject to the $100 floor or the 10-percent of-AGI limitation for personal theft losses.[31] The theft loss is deductible in the year it is discovered, and the amount of the deduction includes the amount invested in the scheme, less any amounts withdrawn, reimbursements, and claims as to which there is a reasonable prospect of recovery.[32] If the theft loss deduction creates or increases a net operating loss (NOL) in the year the loss is deducted, the taxpayer may carry forward the portion of the NOL attributable to the theft loss.[33]

The IRS has also provided an optional safe harbor under which a qualified investor may deduct as a theft loss up to 95 percent of a qualified investment if the investor does not pursue any potential third-party recovery, or 75 percent of a qualified investment if the investor is pursuing or intends to pursue any potential third-party recovery.[34] The deduction is reduced by the amount of any actual recovery, and any recovery from insurance or the Securities Investor Protection Corporation (SIPC).[35]

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[26] I.R.C. § 1221 and Treas. Reg. § 1.1221-1.
[27] I.R.C. § 1001(c)
[28] I.R.C. § 1001(a).
[29] I.R.C. § 64 and I.R.C. § 65.
[30] Internal Revenue Service Rev. Rul. 2009-9.
[31] *Id*.
[32] *Id*.
[33] *Id*.
[34] Internal Revenue Service Rev. Rul. 2011-58.
[35] *Id*.

IV. COMPARE AND CONTRAST APPLICABLE TAX LOSS DEDUCTIONS FOR STOCKS, BONDS, AND DIGITAL CURRENCY

Under current tax rules, investors in virtual currency cannot take advantage of tax loss deductions that would otherwise apply to stock, bond, and other more traditional investment vehicles because virtual currency is treated as property, not a security, for federal tax purposes. Under the current regime, the tax loss rules that apply to investors in virtual currency suffer from inequities and structural problems that do not exist for taxpayers who invest in more traditional investment vehicles, such as stocks and bonds.

In order to eliminate some of these structural inequities (that are beyond the scope of discussion within the context of this paper proposal), the IRS should issue something similar to Revenue Ruling 2009-9 and Revenue Procedure 2009-20 (discussed more fully above) and apply the ruling to taxpayers who suffered losses in and initiated digital currency investments through FTX, its related entities, and other similarly situated cryptocurrency exchanges. If similar rules were issued for cryptocurrency investors, as were allowed for Bernie Madoff investors, the IRS would make it easier for tax practitioners to give well informed advice to their clients who lost their investments following the collapse of FTX. At the time the IRS issued Revenue Ruling 2009-9, its guidance was both timely and welcome, and resolved substantially all of the tax questions confronting taxpayers seeking tax refunds for their Madoff related losses.

V. PROPOSED RESOLUTION

This paper proposal recommends that the IRS adopt and apply Revenue Ruling 2009-9 to investors who suffered losses from investments in a failed crypto currency exchange, such as FTX, its related entities, and similar cryptocurrency exchanges. The facts described in Revenue Ruling 2009-9 (where investors lost money through a traditional style Ponzi scheme) are similar to the facts that occurred in November 2022 when the cryptocurrency exchange FTX and its related entities collapsed into bankruptcy. The factual similarities between the investment losses described in Revenue Ruling 2009-9 and the spectacular and quick downfall of FTX makes this proposal rather simple, logical, feasible and rational.

A. Facts of Revenue Ruling 2009-9

In Revenue Ruling 2009-9, "A" is an individual who uses the cash receipts and disbursements method of accounting and files federal income tax returns on a calendar year basis. "B" holds himself out to the public as an investment adviser and securities broker.

In Year 1, "A" in a transaction entered into for profit, opened an investment account with "B", contributed $100 x to the account, and provided "B" with power of attorney to use the $100x to purchase and sell securities on behalf of "A" . In Year 3, "A" contributed an additional $20x to the account. "B" periodically issued account statements to "A", as well as tax reporting statements to "A" and to the Internal Revenue Service. In Years 1 through 7, "B" reported investment earnings (interest, dividends, and capital gains) to "A", which "A" included in gross income on "A's" federal income tax returns. In Year 8, it was discovered that "B's" purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a "Ponzi" scheme.

"B's" Ponzi scheme, described in Revenue Ruling 2009-9, was operated through the wealth management portion of "B's" business. It was a classic – and, in fact, frighteningly simple – Ponzi scheme. "B" attracted investors by promising them extraordinarily high returns on their investments. However, when investors handed over their money, "B" just deposited the funds into his personal bank account at Chase Manhattan Bank. "B" paid "returns" to earlier investors using the money obtained from later investors. "B's" trading statements, showing "A's" alleged profits, were complete fabrications. Things fell apart in 2008 when a large number of investors wanted to cash out their investments – to the tune of around $7 billion. "B" didn't have anywhere near enough money to cover the requested withdrawals and the fraud came undone.[36]

B. Facts of FTX and Its Related Entities

Compare the facts from Revenue Ruling 2009-9 to the sudden, spectacular, and unexpected downfall of FTX and its related entities. There are many similarities between the collapse of FTX and the collapse of the investment entity described as "B" in Revenue Ruling 2009-9.[37] In both cases, a financial collapse – the 2008 financial crisis for "B" and a crypto market downturn, Covid-19, and soaring inflation for FTX – exposed holes in their businesses and burned the trust their customers once had in them.[38] In the case of FTX, its downfall was as equally quick and stunning as the downfall of "B" in Revenue Ruling 2009-9. The collapse of FTX capped days of whiplash for FTX after its rival and the world's largest crypto exchange, Binance, pulled out of a deal to acquire the company.[39]

FTX was one of the world's largest cryptocurrency exchanges. It enabled customers to trade digital currencies for other digital currencies or traditional money, and vice versa. The company had built its business on risky trading options that are not legal in the United States. It also had a native cryptocurrency known as FTT.[40]

On November 2, 2022, the crypto publication *CoinDesk* reported on a leaked document that appeared to show that Alameda Research, the hedge fund run by Mr. Bankman-Fried, held an unusually large amount of FTT tokens. Binance announced on November 6th that it would sell its FTT tokens "due to recent revelations." In response, FTT's price plummeted and traders rushed to pull out of FTX, fearful that it would be yet another fallen crypto company.[41]

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[36] CFI Team, Bernie Madoff, Corporate Finance Institute (Updated March 15, 2023), Available at https://corporatefinanceinstitute.com/resources/capital-markets/bernie-madoff/#

[37] Edward Helmore, Fraud, cons and Ponzi schemes: did Sam Bankman-Fried use Madoff tactics?, The Guardian (December 17, 2022 0200 EST), Available at https://www.theguardian.com/business/2022/dec/17/sam-bankman-fried-bernie-madoff-fraud-ftx

[38] Id.

[39] Kalley Huang, Why Did FTX Collapse? Here's What to Know, The New York Times (November 10, 2022, Updated November 18, 2022), Available at https://www.nytimes.com/2022/11/10/technology/ftx-binance-crypto-explained.html

[40] Id.

[41] Id.

FTX scrambled to process request for withdrawals, which amounted to an estimated $6 billion over three days. The company entered a liquidity crunch, meaning it lacked the money to fulfill withdrawal requests. This ultimately led to the firm's collapse into bankruptcy.[42]

C. Applying Revenue Ruling 2009-9 to Cryptocurrency

In its indictment of FTX founder Mr. Bankman-Fried, the US Attorney said that since 2019, Mr. Bankman-Fried and his co-conspirators perpetrated a scheme to defraud customers of FTX by misappropriating billions of dollars of those customers' funds. As alleged, Mr. Bankman-Fried used billions of dollars of FTX customer funds (i) for his personal use, (ii) to make investments, (iii) to make millions of dollars of political contributions to federal political candidates and committees, and (iv) to repay billions of dollars in loans owed by Alameda Research, a cryptocurrency hedge fund also founded by the defendant. Mr. Bankman-Fried also allegedly defrauded lenders to Alameda Research and equity investors in FTX by concealing his misuse of customer deposits in financial information that was provided to them. According to the Department of Justice, the charges brought against Mr. Bankman-Fried make clear that this was not a case of mismanagement or poor oversight, but of intentional fraud, plain and simple.

The similarities between the facts described in Revenue Ruling 2009-9 and the downfall and collapse of FTX are so strikingly similar that it makes logical and practical sense to apply the language of Revenue Ruling 2009-9 to the narrow and specific set of cryptocurrency investors who lost their investments following the collapse of FTX. These investors were victims of theft, as the word "theft" is broadly defined for Federal tax purposes. The indictment against Mr. Bankman Fried is sufficient proof (under Federal tax rules) that the cryptocurrency losses from the collapse of FTX resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent because a taxpayer need not show a conviction for theft to claim a theft loss deduction.[43]

At present, there is no other specific guidance on the appropriate tax treatment that should apply to taxpayers who invested in cryptocurrency through a failed cryptocurrency exchange such as FTX. For example, what tax treatment applies to investors and customers who can no longer access funds they invested in or through FTX? Must taxpayers wait until all bankruptcy and criminal justice issues are resolved before these taxpayers can claim a loss on funds they can no longer access?

In sum, the key question is whether the collapse of FTX falls into the realm of Ponzi scemes described by Revenue Ruling 2009-9? Under the factual comparison described above, the answer to this question is "Yes" for all the reasons described in this proposal. In both factual situations, investors suffered losses as a result of intentional fraud, plain and simple. Thus, for the reasons described in this Paper Proposal, the author believes it is reasonable, feasible, and appropriate for the IRS to adopt something similar to Revenue Ruling 2009-9 for investors who lost their investments following the sudden and unexpected collapse of FTX and its related entities.

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[42] Id.
[43] See I.R.S. Publication 547 (Casualties, Disasters, and Thefts), March 2, 2023.

Furthermore, by releasing a Revenue Ruling for cryptocurrency investors similar to Revenue Ruling 2009-9, the IRS would answer some very important questions that have previously been in doubt. For example, Revenue Ruling 2009-9 confirmed that the losses sustained by Madoff investors were considered ordinary theft losses, and not capital losses. The IRS further determined that the losses should be classified as investment related and not personal, which meant that the losses were not subject to the 10 percent adjusted gross income limitation of section 165(h). Nor were the losses subject to reduction under the itemized deduction limitations of sections 67 and 68. Most importantly, the losses were deductible in the year of discovery, which, in this case would mean the losses would become deductible on 2022 tax returns, in the same year Mr. Bankman-Fried's scheme was revealed and criminal charges were filed against him. Applying these same rules to today's cryptocurrency investors would eliminate a lot of confusion for taxpayers and their advisors, counsel, and representatives.

VI. CRYPTOCURRENCY LACKS IMPORTANT PROTECTIONS FOR TAXPAYERS AND INVESTORS, MAKING THIS PROPOSAL EVEN MORE COMPELLING

A taxpayer may deduct a loss from theft of property that is not compensated for by insurance or otherwise.[44] Except in very limited circumstances, cryptocurrency is not classified as a security for federal tax purposes.[45] Nor is cryptocurrency regulated as a security. And none of the major crypto asset entities is registered with the Securities and Exchange Commission (SEC) as a broker-dealer, exchange, or investment adviser – so investors may not get the protections afforded by the rules applicable to these entities.[46] For example, no crypto asset entity is registered with the SEC as a national securities exchange (like, for example, the New York Stock Exchange (NYSE) or the Nasdaq Stock Market). And no existing national securities exchange currently trades crypto asset securities.[47]

As explained more fully in the following paragraphs, all of this makes this proposal even more compelling because investments in crypto asset securities can be exceptionally volatile, speculative, and risky.[48] And the platforms where investors buy, sell, borrow, or lend these securities may lack important protections for investors and taxpayers.[49] As such, the risk of loss for

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[44] I.R.C. §165 and Treas. Reg. §1.165-1.
[45] Under Section 6045(g), as amended by the Infrastructure Investment and Jobs Act (P.L. 177-58) and Treas. Reg. §§ 1.6045-1 and 1.16045-3, for reporting required after December 31, 2023 (for transactions occurring in 2023), brokers are subject to a new reporting requirement if a broker is required to file a return on Form 1099-B to report the gross proceeds from the sale of a covered security. A covered security is any specified security that meets certain requirements as provided by the Internal Revenue Code and Treasury Regulations. A specified security includes a digital asset (virtual currency, cryptocurrency, or other digital token representing value) acquired on or after January 1, 2023.
[46] Id.
[47] Id.
[48] Investor Alerts and Bulletins, U.S. Securities and Exchange Commission, Exercise Caution with Crypto Asset Securities: Investor Alert (March 23, 2023) (Available at: https://www.sec.gov/oiea/investor-alerts-and-bulletins/exercise-caution-crypto-asset-securities-investor-alert#:~:text=In%20particular%2C%20no%20crypto%20asset,or%20the%20Nasdaq%20Stock%20Market)
[49] Id.

individual investors who participate in transactions involving crypto assets, including crypto asset securities, remains significant.[50]

The lack of investor protection increases the risk that cryptocurrency investors may lose their investments, and are less likely to benefit from rules that protect against fraud, manipulation, front-running, wash sales, and other misconduct when cryptocurrency intermediaries do not comply with federal securities laws that otherwise apply to registered exchanges.[51] Indeed, losses from exchange shutdowns, wallet hacks, scams, and other events are unfortunately common in the world of cryptocurrency.[52]

Even more, crypto investors lose the benefit of protections offered by, for example, the Securities Investor Protection Corporation (SIPC).[53] The SIPC was created under the Securities Investor Protection Act, and oversees the liquidation of member firms that close when the firm is bankrupt or in financial trouble, and customer assets are missing.[54] The SIPC protects each customer up to $500,000 for securities and cash (including a $250,000 limit for cash only). It is important to note that the SIPC is not the securities world equivalent of the Federal Deposit Insurance Corporation (FDIC), which insures depositors of insured banks. Coincidentally, people who place deposits in banks enjoy insurance, up to a defined limit, provided by the FDIC. And the National Credit Union Administration (NCUA) insures deposits in Federal credit unions. None of these protections are available for accounts that an investor places with crypto asset entities.

Since cryptocurrency is not regulated as a security, investors who initiated their digital currency investments in or through a cryptocurrency exchange are less likely to recoup their lost investments through entities such as the SIPC, or other forms of insurance. Thus, this proposal is even more compelling and in the overall best interest of cryptocurrency investors who lost their investments due to the collapse of FTX, its related entities, and any similar cryptocurrency exchanges.

As a side note, it is beyond the scope of this paper to conclude whether cryptocurrency is and should be regulated as a security. However, generally speaking, in this author's opinion, cryptocurrency investors would benefit from greater protections and tax benefits if cryptocurrency were classified and regulated as a security.

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[50] Id.
[51] Id.
[52] Miles Brooks, Can I Write Off Lost, Stolen, & Scammed Crypto on My Taxes?, CoinLedger, Available at https://coinledger.io/blog/reporting-stolen-or-lost-cryptocurrency-for-tax-purposes (Last visited April 26, 2023).
[53] Investor Alerts and Bulletins, U.S. Securities and Exchange Commission, Exercise Caution with Crypto Asset Securities: Investor Alert (March 23, 2023) (Available at: https://www.sec.gov/oiea/investor-alerts-and-bulletins/exercise-caution-crypto-asset-securities-investor-alert#:~:text=In%20particular%2C%20no%20crypto%20asset,or%20the%20Nasdaq%20Stock%20Market)
[54] Securities Investor Protection Corporation, Mission, https://www.sipc.org/about-sipc/sipc-mission#:~:text=SIPC%20was%20created%20under%20the,and%20customer%20assets%20are%20missing (last visited April 26, 2023).

VII. CONCLUSION

For all of the reasons outlined in this paper, the author suggests that the IRS adopt and apply Revenue Ruling 2009-9 to taxpayers and investors who suffered losses from investments initiated through a cryptocurrency exchange in or prior to the 2023 tax year.