U.S. TAXATION AND REGULATION OF CRYPTOCURRENCY

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VIRTUAL CURRENCY V. FIAT CURRENCY

FIAT CURRENCIES
USD
EUR
GBP
CHF

VIRTUAL CURRENCIES
Bitcoin – launched in 2009
Litecoin – launched in 2011
Darkcoin – launched in 2014
Dogecoin – launched in 2013

VIRTUAL CURRENCY V. FIAT CURRENCY

- Fiat Currency
  - Fiat currency is legal tender whose value is backed by the government that issued it.
  - US Dollar used to be linked to gold until the 1970s.
  - FinCEN's regulations define currency as the coin and paper of the United States or of any other country that:

    a) is designated as legal tender, and

    b) circulates, and

    c) is customarily used and accepted as a medium of exchange in the country of issuance.

VIRTUAL CURRENCY V. FIAT CURRENCY

- Virtual or Crypto Currency
  - Cypto currency is a digital asset designed to work as a medium of exchange using cryptography to secure the transactions and to control the creation of additional units of the currency.
  - Under the Bank Secrecy Act, 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. FinCEN typically distinguishes between convertible and non-convertible virtual currencies.
  - Convertible virtual currencies either have an equivalent value in real currency, or acts as a substitute for real currency.

VIRTUAL CURRENCY V. FIAT CURRENCY

- There is no physical virtual currency, only logos:

Bitcoin Litecoin Darkcoin

- Uses for Virtual Currency
  - Trading (Investing?)
  - Exchange for Goods/Services

BITCOIN
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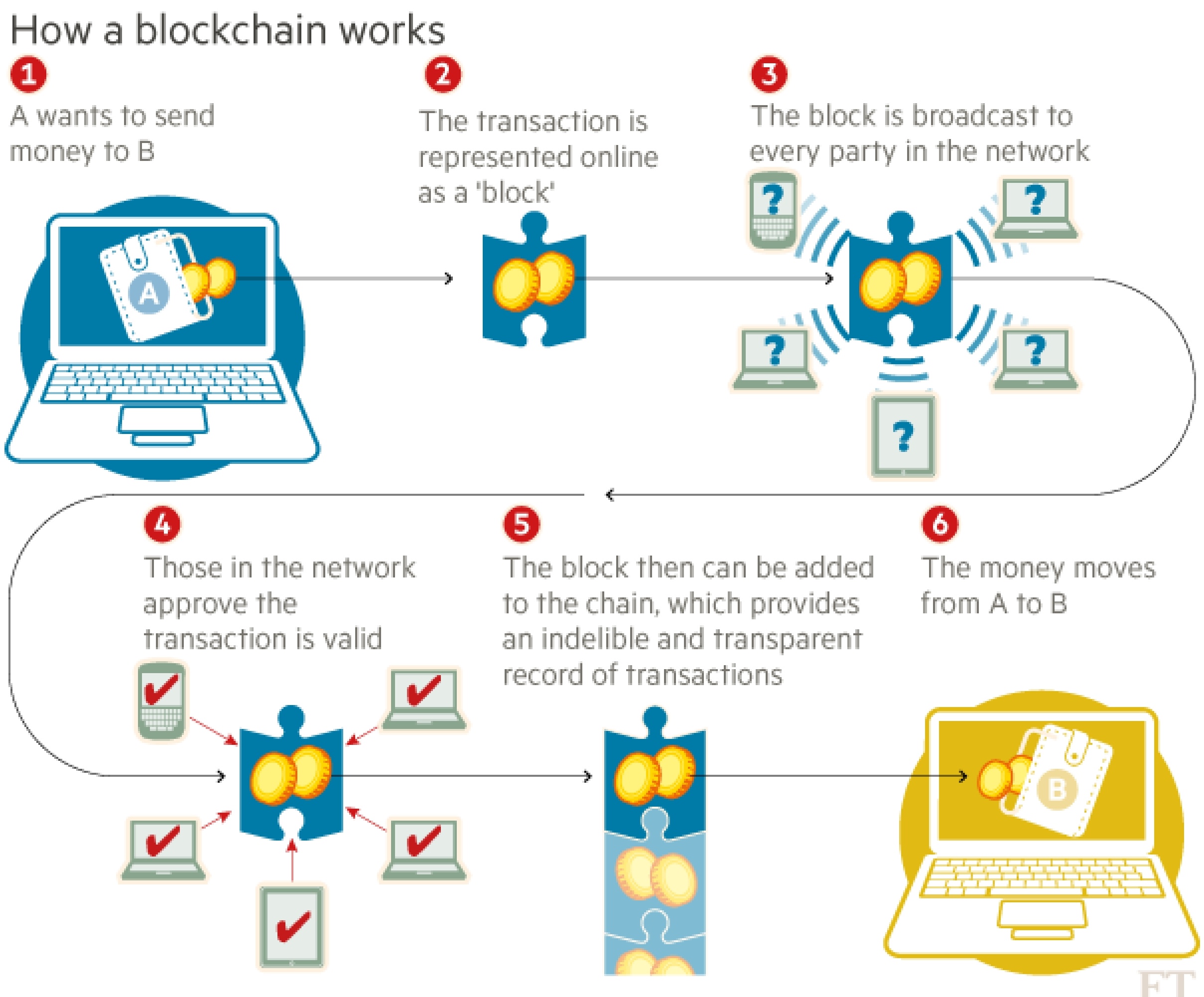
BLOCKCHAIN TECHNOLOGY

- A “block” is a set of transactional data.
- Each block contains:
  - Recent transaction or transactions,
  - Timestamp,
  - Digital signature, and
  - Fingerprint reference to the immediately preceding block.
- Blockchain
  - Chain of transaction data,
  - Recorded and aggregated in these blocks, and
  - Linked by an algorithm to an immutable and linear chain stretching all the way back to the original block.

BLOCKCHAIN TECHNOLOGY

- How it works (from: ft.com):



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BLOCKCHAIN TECHNOLOGY

- Three parties: buyer, seller, and miner.
- Buyer and seller each have a “key”.
- The buyer has a private key which is a secure password for the account that contains their Bitcoins. A sample private key would look like:

  18E14A7B6A307F426A94F8114701E7C8E774E7F9A47E2C2035DB29A206321725
- The seller has a public key which is equivalent to a bank account number. A sample public key would look like:

  3J98t1WpEZ73CNmQviecrnyiWrnqRhWNLy
- Seller provides the buyer with the public key and the buyer enters his private key and the amount of Bitcoins to be transferred to the seller.

BLOCKCHAIN TECHNOLOGY

- The public and private keys are combined and published to the Bitcoin network.
- The Bitcoin network computes the transaction and orders it amongst other Bitcoin transactions using a mathematical formula.
- The network confirms that the buyer owns enough coins to complete the transaction based upon previous transfers and then uses a random mathematical outcome to confirm the transaction. There are thousands of computers all competing to solve the formula at the same time.
- The first computer to solve the mathematical formula associated with the transaction produces a "hash".

BLOCKCHAIN TECHNOLOGY

- A hash is a combination of the private key and the public key which results in a new code such as:

  D61967F63C7DD183914A4AE452C9F6AD5D462CE3D277 798075B10761 5C1A8A30

  This code is a one directional code. Anyone can see what the buyer's and seller's keys are but you cannot alter the keys without changing the hash.

- The individual computer publishes the hash to the network. Other computers verify the hash is correct.

  If the hash is correct it goes into the Blockchain.

BLOCKCHAIN TECHNOLOGY

- The computer that correctly generated the hash is rewarded with new Bitcoins.
- The number of Bitcoins awarded is based upon the original Bitcoin code and the number of Bitcoins currently in existence.
- This process of verifying transactions in exchange for new Bitcoins is called Mining.

INCOME TAX TREATMENT OF VIRTUAL CURRENCY, IRS NOTICE 2014-21

- Virtual Currency Treated as Property
  - General tax principles applicable to property transactions apply to transactions using virtual currency.
    - Fair market value (FMV) of the property is the amount realized.
    - Amount received must be measured in U.S. Dollars.
  - The basis of virtual currency received as payment for goods or services is the FMV of the virtual currency in U.S. dollars as of the date of payment or receipt.
    - Determined by value listed on an exchange.

- Gains on Holding Virtual Currency
  - If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain.
  - The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.
  - Character of the Gain/Loss:
    - Capital if considered a capital asset (stocks, bonds, etc.).
    - Inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset.

- Income from Mining
  - The FMV of the virtual currency as of the date of receipt is includible in gross income.
  - Activities could constitute self-employment income and are subject to the self-employment tax.
  - The FMV of virtual currency received by an employee is wages subject to withholding.

- Reporting of Virtual Currency Transactions (Form 1099-K)
  - Third party settlement organization (TPSO) may be required to report payments made to a merchant on a Form 1099-K, Payment Card and Third Party Network Transactions, if:
    - The number of transactions settled for the merchant exceeds 200 and
    - The gross amount of payments made to the merchant exceeds $20,000.

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AICPA COMMENTS ON VIRTUAL CURRENCY GUIDANCE

1. Expenses in Obtaining Virtual Currency
   a. Expenses should be deducted as incurred
   b. Expenses for mining equipment should be capitalized

2. Valuation and Documentation
   a. Taxpayers should use reasonable and consistent methods
   b. Taxpayers may use exchange averages

3. Computation of Gain / Loss
   a. Taxpayers may use specific identification or FIFO

4. De Mininimis Election
   a. Suggestion that $200 / transaction be excluded as de minimis

5. Valuation for Charitable Contribution
   a. Virtual currencies that have FMV on two exchanges can be treated like publicly traded stock

AICPA COMMENTS ON VIRTUAL CURRENCY GUIDANCE

6. Chain Splits / Airdrops / Giveaways / Token Swaps / Staking

7. Virtual Currency Held by a Dealer
   a. Virtual currency treated as inventor when used in business
   b. Virtual currency could generate capital gain when paid outside of business context
   c. Traders / Dealers consider a “mark-to-market” election

8. Like-Kind Exchanges under IRC 1031

9. Installment Arrangements under IRC 453

10. Assets in Retirement Accounts

11. FBAR Reporting

INITIAL COIN OFFERINGS

- Equity
  - Tokens with rights to distributions, rights to a share of profits, or voting rights
- Debt
  - Tokens characterized as debt: definite obligation to repay the investor with interest
  - No current tax to either the issuer or investor, but deemed interest payments or COD income if debt is forgiven
- Prepaid good/services
  - Tokens may represent the ability to acquire goods or services provided on the platform and, as such, may be characterized as a prepayment for such goods or services.

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TRACKING USE OF VIRTUAL CURRENCY

- Treasury Inspector General for Tax Administration Report, September 21, 2016 “As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance”
  - Report Found:
    - IRS does not have any compliance initiatives or guidelines for conducting examinations or investigations specific to tax noncompliance related to virtual currencies.
    - It does not appear that any of the actions already taken by the IRS to address virtual currency tax noncompliance were coordinated to ensure that the IRS maintains a strategic approach to the tax implications of virtual currencies.
    - Third-party methods of reporting taxable transactions to the IRS do not separately identify transactions related to virtual currencies.

TRACKING USE OF VIRTUAL CURRENCY

- TIGTA Recommendations:
  - IRS develop a coordinated virtual currency strategy that includes outcome goals, a description of how the agency intends to achieve those goals, and an action plan with a timeline for implementation.
  - IRS provide updated guidance to reflect the necessary documentation requirements and tax treatments needed for the various uses of virtual currencies.
  - IRS revise third-party information reporting documents to identify the amounts of virtual currencies used in taxable transactions.

TRACKING USE OF VIRTUAL CURRENCY

- IRS Continued Actions:
  - In December 2013, the IRS established the Virtual Currency Issue Team (VCIT) to better understand how virtual currencies may affect taxable transactions and identify potential areas of noncompliance. The VCIT is comprised of various members from the IRS and the IRS Office of Chief Counsel.
  - Considering public comments received in response to Notice 2014-21.
  - Analyzing whether changes to information reporting documents would assist in identifying noncompliance related to virtual currency transactions and assessing the cost and impact to filers of these information returns, as well as taxpayer burden.

TRACKING USE OF VIRTUAL CURRENCY

- IRS Enforcement Measures
  - On November 30, 2016, the federal court in the Northern District of California authorized issuance of IRS John Doe Summons on Coinbase, Inc., a virtual currency exchange.

  - Narrowed to users with at least $20,000 in any one type of transaction (buying, selling, sending, or receiving) in any single year between 2013 and 2015.

  - U.S. District Court held
    - the narrowed summons served the legitimate purpose of investigating the "reporting gap between the number of virtual currency users Coinbase claims to have had during the summons period" and "U.S. bitcoin users reporting gains or losses to the IRS during the summoned years."
  - Court reasoned
    - the discrepancy "creates an inference that more Coinbase users are trading bitcoin than reporting gains on their tax returns," indicating the IRS has a legitimate interest in investigating these taxpayers.

OTHER REGULATORY HURDLES FOR VIRTUAL CURRENCY EXCHANGES

- U.S. Treasury Department Financial Crime Enforcement Network ("FinCEN")
  - Any financial institution, payment system, or medium of exchange has the potential to be exploited for money laundering.
  - Fighting such illicit use requires consistent regulation across the financial system.
  - Virtual currency is not different from other financial products and services in this regard.

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OTHER REGULATORY HURDLES FOR VIRTUAL CURRENCY EXCHANGES

- FinCEN's regulatory approach:
  - The regulatory framework for money services businesses, which include virtual currency exchangers and administrators, has been in existence for years.
  - So how did FinCEN approach virtual currency?
    - AML protections must keep pace with the emergence of new payment systems, lest these innovations become a favored tool of illicit actors.

OTHER REGULATORY HURDLES FOR VIRTUAL CURRENCY EXCHANGES

- FinCEN's regulatory approach (continued):
  - What is important is that financial institutions that deal in virtual currency put effective AML/CFT controls in place to harden themselves from becoming the targets of illicit actors that would exploit any identified vulnerabilities.
  - FinCEN became one of the first agencies in the world to clarify regulations relating to virtual currency.
  - FinCEN issued guidance (FIN – 2013 – G001) in March 2013, noting that virtual currency exchangers and administrators are "money transmitters" under the Bank Secrecy Act (BSA) and its implementing regulations.

Money Transmitters are required to register with FinCEN as a money services business and institute certain recordkeeping, reporting, and AML program measures.

OTHER REGULATORY HURDLES FOR VIRTUAL CURRENCY EXCHANGES

- Money transmitter rules
  - Money transmission services means the acceptance of currency, funds, ***or other value that substitutes for currency*** from one person and the transmission of currency, funds, ***or other value that substitutes for currency*** to another location or person by any means.
  - Regulations for money transmitters: registration, AML Program, mandatory reporting.

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OTHER REGULATORY HURDLES FOR VIRTUAL CURRENCY EXCHANGES

- Administrators and Exchangers are subject to money transmitter rules.
  - Exchangers:
    - person involved as a business in the exchange of virtual currency for fiat currency, funds or other virtual currency.
  - Administrator:
    - person involved as a business in issuing virtual currency and who has the authority to redeem (withdraw from circulation).

CONTACT INFORMATION

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- Stephen Turanchik, Esq., is an attorney in the Tax Department at Paul Hastings LLP where he specializes in civil tax controversy and litigation.
- He is a former Trial Attorney of the U.S. Department of Justice, Tax Division, Northern Region where he tried four jury trials and dozens of bench trials.
- Steve earned his J.D. from Fordham University School of Law and his LL.M in Taxation from New York University School of Law.
- Steve is an active member of various taxation sections including the California State Bar Association, as well as local bar associations. Steve is the former Chair of the Taxation Section of the Los Angeles County Bar Association (LACBA).
- Steve also teaches as an Adjunct Professor at Loyola Law School and was previously an Adjunct Professor for Graduate Tax Program at Golden Gate University.

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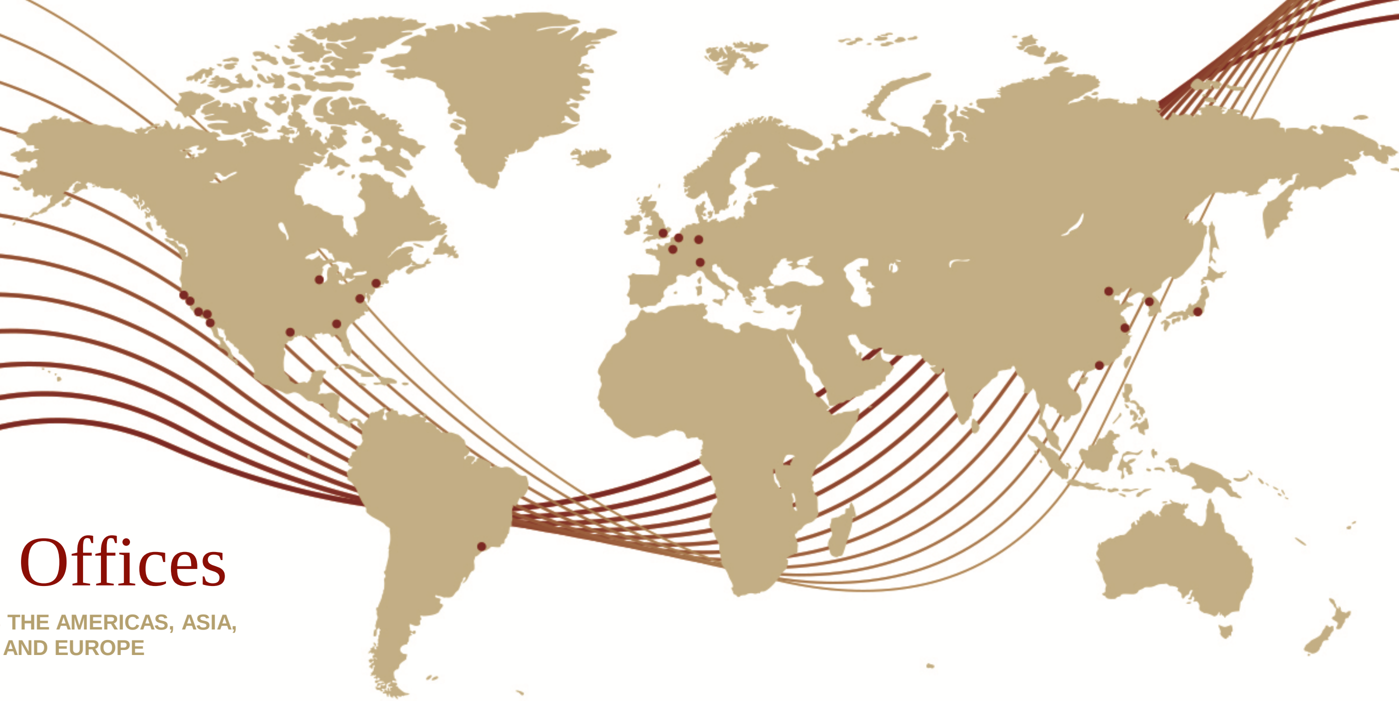

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