


CRYPTOCURRENCY: TAX & OTHER LEGAL ISSUES



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1

1

The Crypto Winter

- Crypto winter begins in late 2021 as inflation spikes fears of interest rate hikes (see Bitcoin example right)
- In May of 2022, stablecoins (pegged to US dollar) face instability; Terra USD and Luna dove below \$1. Luna collapses and \$40 billion evaporates.
- By June of 2022, Celsius pauses and Binance halts withdrawals. Bitcoin and Ether plummet in value.
- In July of 2022, Celsius files for bankruptcy.
- In September of 2022, Sam Bankman-Fried (FTX's CEO) suggests he might be able to use FTX funds to bail out the industry.

Bitcoin Value as of June 2022



Market stats

Market cap	\$403B	▼
30% of crypto market		
Volume (24h)	\$23B	▼
+5.50%		
Circulating supply	19M BTC	▼
9% of total supply		

2

2

The most disastrous week in Crypto history.....

- Bitcoin valued at approx. \$16,500 as of 11/17/22, down from an all time high of approx. \$68,700 just over a year ago!
- FTX goes from \$32 billion in valuation to bankruptcy!
- What happened?
 - FTX's sister company, Alameda, had an outsized amount of FTT (native currency of FTX) on its balance sheet
 - Binance liquidates its FTT holdings
 - Run on deposits leaves FTX with \$8 billion shortfall
 - Binance offers to buy FTX, but then pulls out after due diligence
 - Trading on FTX halts and FTX sustains cyberattack
 - Once darling of regulators and investors, MIT grad & crypto guru, Sam Bankman-Fried resigns as CEO of FTX
- What happens now?
 - FTX could owe money to more than 1,000,000 people
 - FTX could be investigated by dozens of regulators as theories mount that FTX improperly transferred funds to Alameda
 - Regulation is likely to be welcomed and required

3

3

What is Crypto Currency anyway?

Fiat Currency

- Physical
- Issued by centralized government
- Regulated by law and banks (may even be insured)
- Value determined by both the market and regulation
- Tied to a nation state
- Ownership records private

Cryptocurrency

- Digital - code
- Created by computers on a block chain platform through mining or proof of stake
- Decentralized and unregulated (not controlled by any government)
- Value determined by supply and demand
- International – not tied to any nation state.
- Ownership records public but pseudonymous



4

4

How do you buy or sell Crypto? What's a Crypto Wallet?

- Stores private keys that access your assets on the blockchain
- Your private keys or password prove your ownership of digital money and allow you to engage in transactions.
- No Keys, No Crypto – if you lose the keys, you lose access to your money.
 - Subject to mistakes (send to the wrong person and it's gone)
 - Wallet subject to hacks and phishing
 - According to NY Times article in 2021, of the 18.5 million Bitcoin that was circulating at that time, about 20% (then worth \$140 billion) appeared to have been lost or stranded where people don't have access to their passwords in their wallets.



5

5

Understanding how the technology works is the first step to understanding how current our current laws apply to cryptocurrency and related blockchain technologies...



6

6

Blockchain: The foundation

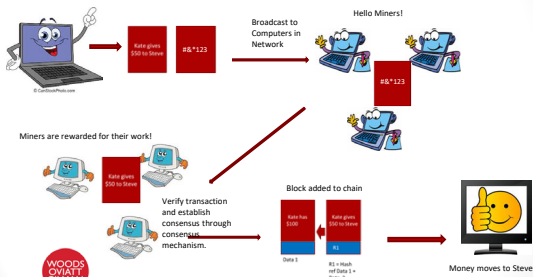
The term "Blockchain" is generally used to describe a "distributed ledger technology" (DLT), an electronic record of data, that is:

- **Decentralized:** many nodes (computers) that connect to each other (but not through one central computer) and maintain copies of the same ledger
- **Distributed:** to network participants (nodes around the world "gossip" to share the same exact ledger, its transaction history and receive the new inputs)
- **Self-Proving:** nodes compete solve mathematical puzzles to validate the data (mining), add "blocks" to the chain, and reconcile inconsistencies through a "consensus mechanism"
- **Time Verified:** each ledger entry is hooked to the prior ledger entry ensuring an accurate chronology
- **Immutable:** difficult to change prior blocks
- **Secure:** encrypted with private/public keys



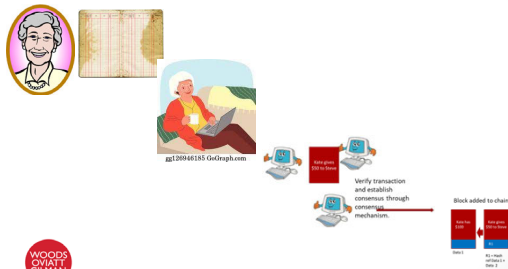
7

Visualizing: Building the Blockchain



8

Visualizing: The Evolution of the Distributed Ledger...



9

Applications for Blockchain...

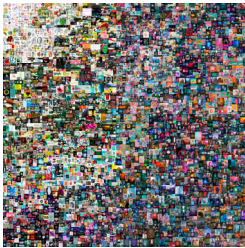
- Cryptocurrency
 - Bitcoin
 - Ethereum
 - (many others)
- Non-Fungible Tokens
- Tokenized Asset
 - Community memberships
 - proof of attendance
 - gaming
 - real estate investment
- DAO – Decentralized Autonomous Organizations –
 - Membership organization/ community
 - Rules encoded on computer program
 - Transaction records on block chain
 - Tokens may be used for governance
- Records & More



10

10

Sold for \$69,000,000?



Example: "The First 5000 Days" sold by Christie's 2/2021
<https://www.nytimes.com/2021/02/11/arts/design/nft-auction-christies-beagle.html>



11

11

What is a NFT?

- NFT – "Non-Fungible Token" – is a token that represents a unique item, such as a piece of art, song, video clip – Digital certificate of authenticity
- Non-Fungible
 - Unique
 - Provably scarce
- Ownership – A NFT can have only one true owner at a time and they are secured by a smart contract on blockchain / Fractional NFTs being explored
- NFTs are generally sold on NFT market places such as Opensea, Rareable, and Nifty Gateway
- Sold by artists, athletes, brands
- Value based on supply and demand



12

12

How do you mint and define the rights to a NFT?

- What is Minting?
 - Cryptocurrency platform base (Ethereum, Solana)
 - Digital file
 - Smart contracts (computer code)
- What define the rights to the NFT?
 - Linked Digital Asset Contract?
 - Terms and conditions
 - Rights of each party
 - Transfer rights
 - Transfer fees
 - Royalties,
 - Indemnification
 - Etc.



13

Current IRS Guidance

- Notice 2014-21
- Rev. Rul. 2019-24
- IRS FAQs on Virtual Currency Transactions
- CCA 202035011, CCA 202114020, CCA 202124008, PLR 202019028



14

Digital Assets Defined

- "Any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary."

IRC § 6045(g)(3)(D).



15

Digital Assets:

Non-fungible digital assets (e.g., NFT)

Fungible digital assets

Cryptocurrency (e.g., Bitcoin)

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16

Virtual Currency Defined

- "A digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value."
Notice 2014-21.
- Not real or foreign currency.
- Includes "**convertible virtual currency**" such as cryptocurrency.

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17

17

Taxed as Property

- Virtual currency is taxed as property.
 - So exchanging for other property (including other virtual currency) triggers gain or loss.
 - Capital gain or loss if a capital asset.

Notice 2014-21; IRS FAQs 2 and 4.

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18

18

What Type of Property?

- Commodity or security? Neither?
 - Lack of Code definitions.
 - Commodities Futures Trading Commission (CFTC)—a commodity
 - Securities Exchange Commission (SEC)—agrees with CFTC regarding bitcoin

See Rev. Rul. 73-158.



19

Mining & Staking

- Mining: Rewards are ordinary income when received.

Notice 2014-21.

- Staking: Rewards likely ordinary income when received.
 - Jarrett v. U.S., No. 3:21-cv-00419



20

Hard Forks & Airdrops

- Rev. Rul. 2019-24:
 - Hard forks do not generate income
 - Airdrops of new units generate ordinary income if dominion and control.

See also IRS FAQs 22 and 23.



21

Compensating in Virtual Currency

- Wages subject to withholding, FICA and FUTA if services performed as an employee.
- Self-employment earnings subject to SECA taxes if services performed as an independent contractor.
- *Note:* Virtual Currency is not a permissible form of payment under US employment law.

Notice 2014-21.



22

22

Gifting Virtual Currency

- Donee has no income until disposition.
IRS FAQs 31, 32 and 33.
- Cryptocurrency can be lost forever without proper planning
 - Consider state unclaimed property laws



23

23

Donating Virtual Currency

- If a long-term capital gain asset, then charitable deduction equals the fair market value when donated.
- Charities treat the donation as a non-cash contribution.

IRS FAQs 34 through 37.



24

24

Non-Fungible Tokens (NFTs)

- No specific IRS guidance
- What property rights are sold...
 - By creator in primary market
 - By investor in secondary market
- Collectibles gain rate?
- Income sourcing issue



25

25

New Reporting Requirements

- After 12/31/23...
 - Form 8300: Cash includes digital assets.
 - Form 1099-B: Digital assets are classified as specified securities subject to broker information reporting.

Infrastructure Investment & Jobs Act, P.L. 117-58 (11/15/21)



26

26

A General Partnership, ~~But~~ DAO

Carrie Coder, a college student, teaches herself coding and creates an NFT collection. It sells out instantly. A non-US person reaches out to Carrie and offers to help take the next NFT collection to the next level. They hit it off and work on the next NFT collection, which turns out to be an even bigger success. They come to you because they have heard about, and decided they need, a DAO (“decentralized autonomous organizations”).



27

27

Trust Me, We're Friends

A self-taught cryptocurrency investor understands the ins and outs of cryptocurrency so well he quits his day job to focus on trading cryptocurrency. He brags about his investments to all his friends. His friends, who know far less about crypto, ask him to invest in crypto for them.



28

28

To Tokenize, or Not to Tokenize

A real estate developer asks you to form an LLC that will bring on outside investors in a new project. He asks whether at some point in the future, the LLC can tokenize its interests on a cryptocurrency exchange. He believes this will help provide a liquidity event for investors.



29

29

Pay Me in Crypto

A start-up company is developing tokens on a token network and wants to incentivize key employee developers with token awards. Can they do this?



30

30
