Tax Lawyers Find New Obstacles Defending Client Crypto Positions

By Nathan J. Richman

The same things that some cryptocurrency buyers like about the instrument could pose trouble when it comes to trying to defend taxpayers in audits or court proceedings.

The IRS's position is that taxpayers moving their cryptocurrencies between their own wallets haven't engaged in taxable transactions, but while some taxpayers may try to hide behind the perceived anonymity, others are finding that it makes it hard to prove to revenue agents that they hold all those wallets.

"On the civil side, the anonymity is a problem in civil audits because I had a devil of a time proving to the agents that my client actually owned the wallets to which money was transferred from Coinbase," John M. Colvin of Colvin + Hallett Law said May 14 during the American Bar Association Section of Taxation meeting.

Seeing what looked like money coming in, the auditors guessed it was income to the taxpayer, according to Colvin. When asked to confirm common ownership using one set of programs, the taxpayer declined, creating a frustrating situation in which the partial anonymity hindered their position, he said. The case finally settled at the IRS Independent Office of Appeals, he added.

"There's also an issue such as if you have a business, and the business has a cryptocurrency wallet. How can you tell if it's the business's wallet versus an individual's? Because they're really tied to an individual," Evan J. Davis of Hochman Salkin Toscher Perez PC added. "That's going to be an emerging problem."

The IRS and other agencies already have to figure out the proper tax treatment for cryptocurrencies — the primary position in Notice 2014-21, 2014-16 IRB 938, is that transactions in cryptocurrency are treated as transactions in property — and how to find potentially misreported cryptocurrency. Further down the line, as tax controversies and investigations progress, they will also have to consider how to use information about the decentralized blockchain in court — for example, how to introduce blockchain evidence and how to authenticate it.

Taking a Gamble

Another challenge discussed at the ABA meeting May 13 concerns when it's time to pick a comparison to use when trying to defend a position.

"I'm getting more questions on the mining-versus-staking analysis and the timing of that income recognition — is it a service like mining?" Andrea Mouw of Eide Bailly LLP noted.

Mouw said one of her clients described staking as more like the gambling that the compensation for services invoked in Notice 2014-21. "You're effectively putting up collateral that this transaction is viable, so in their mind it's very different than mining," she explained.

Christopher Wrobel of the IRS Office of Associate Chief Counsel (Income Tax and Accounting) pointed to another holding in Notice 2014-21 that says cryptocurrency validation rewards are treated as compensation for services, acknowledging that the guidance addresses mining rewards. "Do you see a difference between the treatment of mining and staking?" he asked.

Mining generally refers to proof-of-work validation protocols for cryptocurrency networks, and it depends on using enormous amounts of computing power to solve complex math problems for the chance to validate the next block in a blockchain. The most prominent cryptocurrency, bitcoin, uses a mining validation protocol.

Staking, another name for the proof-of-stake validation protocol, instead distributes the right to validate a new block based on users devoting some of the tokens they hold on the network as a pledge. Users in either mining or staking protocols generally receive some new network tokens when validating the new blocks.

Another taxpayer has argued that staking rewards are instead created by the validators as part of the process of building the new block. While the government has moved to dismiss that case as moot because the IRS paid the $4,000 refund Joshua and Jessica Jarrett requested, some commentators have pointed to the case when arguing for more guidance on a variety of cryptocurrency tax issues.

Kristen Martin of Deloitte Tax LLP said she's also fielding lots of client questions about staking rewards. "Some other common questions I'm seeing are the basis treatment [and] the treatment of stablecoins, especially if they're pegged to the U.S. dollar," she said.

Martin posed two example questions: Are those assets treated as cash equivalents? Do they fall under the IRS's virtual currency FAQs?