

Crypto asset management:
Managing the tax expectations gap

Setting the stage

In the past few years, we have witnessed an exponential growth of both interest and investment in digital assets and cryptocurrencies. New players have launched funds and investment vehicles with trading strategies specifically designed to capitalize on these opportunities and manage the risks associated with digital and crypto assets. Established investment management funds are also exploring this new frontier. In fact, digital assets have now become a recommended asset allocation in many portfolios.

As with all new frontiers, the rules governing this space are not fully established. And that's true for tax too. The Internal Revenue Service (IRS) has yet to issue what we might deem full guidance on how income and gains with respect to these assets are to be taxed or how to specifically classify the assets and transactions—that is, securities or commodities? In the absence of full guidance, players in this space need to proceed with caution to better manage the expectations gap between what they think or assume is the right tax treatment and what may well prove to be true in the event of an IRS audit. So, yes, we're dealing with asset management. But these assets are far from conventional.

This publication offers an outline of some of the key issues and pitfalls that may warrant your attention when investing or otherwise transacting in crypto. Given the complex and unresolved issues related to taxation of crypto, a more comprehensive analysis of your specific circumstances is merited.

There are, nevertheless, some important IRS guideposts that offer some sense of direction and help to narrow the expectations gap.

1 [IRS Notice 2014-21](#) explains that certain digital assets, notably “virtual currencies,” are to be treated as “property” since they do not have “legal tender status.” The implication then is clear: Transactions in crypto/virtual currencies are barter transactions (property for property exchanges). (See the Deloitte whitepapers, [Corporates investing in crypto](#) and [Corporates using crypto](#).) Such property is not “foreign currency” under the tax code, and transactions in such digital assets are not eligible for treatment under sections 985–989 and the regulations thereunder.

2 [IRS Rev. Rul. 2019-24](#) provides guidance on the tax implications for gross income of “hard forks”—when, per the IRS, “a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger.”

3 [IRS Q&As](#) provide broad guidance on some 40-plus questions, from defining cryptocurrencies to completing Form 1040 and determining whether a gain or loss is short or long term, etc.

While helpful, much of this guidance is preliminary and is not necessarily definitive.



WHAT ARE THE IMPLICATIONS?

- There are no general, one-size-fits-all tax treatments for every investing or other transacting strategy in digital assets and cryptocurrencies. Each investing strategy will have its own peculiarities and characteristics that differ from those investment strategies involving traditional assets.¹
- Consequently, each digital asset needs to be understood and scrutinized not only in terms of its characteristics as a digital asset but also with regard to the protocols and terms and conditions governing these transactions on the blockchain.
- The best defense is a good offense. Be proactive in asking about and understanding the terms, conditions, and tax implications of the digital assets in which you are investing. Even the best of intentions can result in unintended tax pitfalls.
- When asset managers take the necessary steps to understand the tax implications of their transactions using digital assets, those structuring benefits are passed on to their investors.

Select tax considerations

Broadly speaking, in the asset management space, there are two categories of taxpayers/funds transacting in digital assets:

- 1 *Investors* who tend to hold assets for longer periods (often more than a year).
- 2 *Traders* who seek to make a profit from short-term swings in the market from transacting capital for the proprietary account of the taxpayer/fund.

These strategies, when applied to investing or trading in digital assets, produce different results for funds that have foreign investors.

Note: There is significant judicial precedent that requires evaluation of the particular facts and circumstances for determining when taxpayers are engaged in an investing or a trading activity; however, there is no bright-line test on whether a strategy would be considered that of an “investor” or “trader.” It is recommended that you make this determination with your tax adviser. Moreover, the status of “investor” or “trader” should be evaluated annually.

WHAT ARE THE IMPLICATIONS?

- [Trading Safe Harbor](#) is a matter of some concern given the global reach of many asset management companies and their clientele. And that, of course, brings up the issue of whether foreign taxpayers are treated as engaged in a US trade or business and have taxable [Effectively Connected Income](#) (ECI) for US-based trader funds investing in digital assets on behalf of their foreign limited partners (LPs). Here again, we need to be alert to an expectations gap.
- For US domestic taxpayers who often invest in funds through “feeder” partnerships that provide flow-through treatment to such domestic persons, investor treatment compared to potential trader treatment is also relevant to determine

whether the fund may elect mark-to-market treatment for proprietary trading in commodities pursuant to section 475(e) and claim ordinary gain and loss treatment in lieu of short-term capital gains and losses that otherwise result from regular trading in commodities. Such mark-to-market treatment may also be relevant for mitigating deferral of losses from straddle treatment (under section 1092), which may result from any longer-term investment assets held in connection with a broader trader operation. Such eligible treatment under section 475 is always dependent on first qualifying the crypto as a “commodity.” See discussion under the “Basis tracking and lot relief” section in this article.

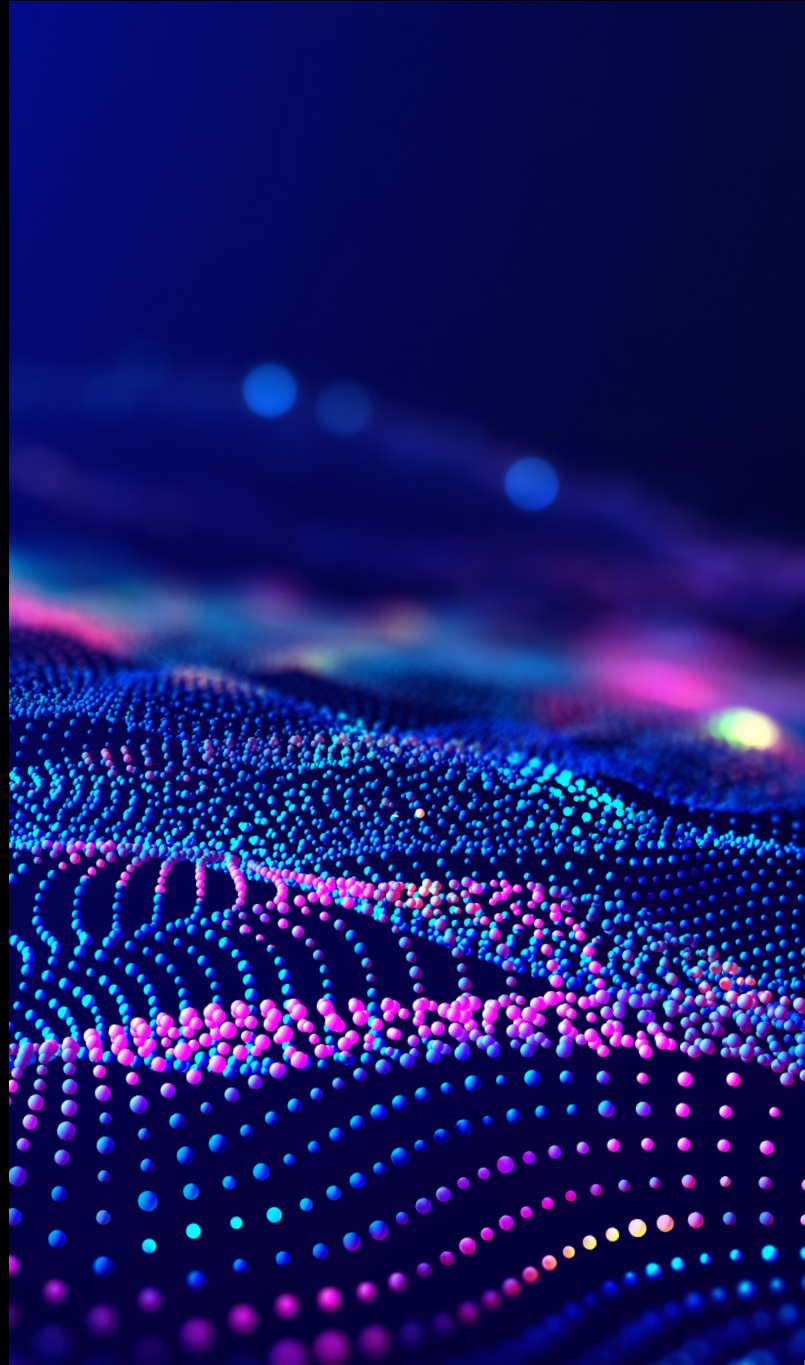
- 3 Traditionally, “proprietary trader” funds that regularly transact in “securities” or “commodities” as defined in the Internal Revenue Code (IRC) could usually rely on [IRC section 864\(b\)\(2\)](#) to avoid having the funds (and generally, their foreign partners) treated as engaged in a US trade or business with respect to such trading activity. Gains and losses are not fixed or other determinable and periodic income and are not subject to gross basis tax or withholding except in rare circumstances applicable only to foreign residents who spend over 183 days in the United States. However, if funds are regularly trading in the United States and such activity is not eligible for a trading safe harbor under section 864(b)(2), then such funds may become engaged in a trade or business in the United States, and if trading is conducted through a US fixed place of business or through a US office of a dependent agent, then such gains of flow-through partnerships are subject to withholding taxes through estimated payments on their foreign LPs’ allocable share of ECI, whether or not such ECI is with respect to capital gains or ordinary gains.

- As most crypto assets remain “undefined” as either securities or commodities by the IRS, it is possible that any gains from these activities could be subject to ECI withholding.
- The determination of whether such gains are attributable to a US office or fixed place of business of the fund is a complicated inquiry that requires coordination with a tax adviser.



WHAT ARE THE IMPLICATIONS?

- If your fund's strategy can be defined as that of a "trader fund," it may be beneficial to analyze the geographical operations related to those digital assets.
- **Issues to keep in view** – Broadly put, funds that trade in crypto should keep the following considerations in view for coordination:
 - **Characterization of the crypto**
Whether the crypto (including derivative transactions entered into with respect to crypto) qualifies as a commodity or security for purposes of section 864(b) and for section 475(e) and/or 475(f).
 - **Scope of "investing" or "trading" activity**
Whether the scope of activity rises to the level of "trading" under US principles or constitutes mere "investing."
 - **Trading attributable to a US office or fixed place of business**
Whether any regular trading activity is conducted through a US office or fixed place of business of the fund (e.g., registering or administering the fund through a US office in the US manager's office), including whether a US-based manager has a carried interest owned and payable within the United States or whether the US-based manager exercises its trading role as a dependent agent of the fund.
 - **Customer transacting**
Whether the fund (through the activities of the US manager) regularly offers, stands ready to, and, in fact, enters into either side of a transaction with customers—crypto lending transactions require specific scrutiny for this potential characteristic.



Basis tracking and lot relief

In the world of conventional investments, funds acquire and sell vast quantities of shares of a given company over a period of years and at different prices. Sophisticated funds and their custodians use the “specific identification” method to track the time and price of each share purchased and sold. That enables the funds to gain a more favorable tax position by selecting which shares to sell at what price and when. Absent the ability to track individual shares, the IRS requires the use of “first-in first-out” (FIFO) tax accounting, which presumes that the shares sold are the shares first acquired. As a fixed presumption, FIFO does not offer the flexibility of specific identification and may not result in the most favorable tax results.

The use of specific identification for digital assets can be particularly beneficial because of their historically high volatility. But maintaining sufficient books and records to support specific identification for digital assets poses significant challenges because of their inherent fungibility. These challenges can be compounded when digital assets are held both directly and through a custodian and where holdings are spread across multiple custodians. And the blockchain implementation for certain digital assets makes identification on an item-by-item basis very difficult.

A basic tool to support specific identification is to segregate digital assets into classes or “buckets” whose tax characteristics are known and whose transactions can be identified. Segregation can be maintained in various ways, including separate accounts and multiple digital wallets.

Hence, funds need to segregate and identify their digital asset tranches to avoid FIFO as the default method recognizing gain/loss.

In lieu of other options, one popular basis tracking/lot relief methodology includes segregating tranches of acquired assets into distinct electronic wallets.

- Bear in mind that not all wallets are the same. In some cases, a wallet can hold a variety of digital assets since many wallets serve essentially as amalgamating instruments. In other instances, wallets can point to a single address on the blockchain where the coin(s)/asset(s) reside. It’s somewhat similar to the difference between having a leather wallet that carries a variety of \$10 bills with different serial numbers, debit cards, etc. versus having one wallet for each \$10 bill with its specific serial number. In the world of crypto, the latter case may allow for even greater precision in basis tracking. Your specific needs and circumstances will help determine the kinds of wallets you create.
- Funds develop wallet structures to house different tranches of their digital assets with similar cost bases and holding periods. Hence, when it comes time to sell, a given wallet or tranche should be readily distinguishable from another, and relevant information should be at hand—date and time each unit was acquired, basis cost and value of each unit at the time it was acquired, or wallet created; and finally the price of each unit when it was sold.
- Additional basis tracking consideration needs to be given to the straddle rules and how they may apply to a trading strategy. That will help ensure that the proper data points are generated to calculate any adjustments.
- Pending legislation for the application of wash sales and constructive sales to digital assets is likely to reinforce the significance of accurate basis tracking. These pending rules could also have broader implications for many other tax positions currently being taken, such as the taxability of distributions, trading safe harbors, and a variety of other situations.

In addition, a section 475(f) election (mark-to-market) may provide a possible alternative if the assets traded by the fund meet the definition of a commodity or a security for that purpose. So, rather than use the Specific ID method, funds could determine the value of their assets using [mark-to-market pricing](#) and pay taxes accordingly.



WHAT ARE THE IMPLICATIONS?

- Section 475(f) election may be attractive to funds that trade in large volumes and hold assets short term and for which Specific ID would be a too costly and time-consuming process.
- One significant challenge remains: A 475(f) election may not be feasible if the relevant digital asset is not considered a commodity or security for this purpose. For some of the better-known and more widely traded digital assets, that may be easier. For more exotic and complex crypto assets, funds may need to do a deeper dive to determine how/if they might present a case to the IRS that the asset in question meets the definition of a commodity/security for purposes of section 475.



Mining and staking rewards

Let's begin with two simple definitions.

1 Mining of cryptocurrencies simply means that an operator on a blockchain gains a reward in cryptocurrency for completing blocks of verified transactions that are then added to the blockchain. Those blocks contain vast amounts of information about myriad transactions that need to be checked and bundled together like a puzzle, using an appropriately developed algorithm.

2 Staking, on the other hand, requires holding crypto funds in a wallet to support the operations and security of a blockchain—it is roughly analogous to helping ensure the liquidity of capital markets. In a Proof-of-Stake (PoS) protocol, node operators will retain the blockchain's native cryptocurrency in an address or smart contract linked to their node—proving ownership and thereby limiting the risk they will partake in malicious acts while recording and validating blocks. Like mining, when new blocks are recorded and/or validated, these nodes will earn block rewards. Delegated PoS protocols allow owners of the native cryptocurrency to partake in the block generation and validation process by linking their crypto holdings to nodes owned and operated by other parties in order to earn rewards (less any commissions or fees charged by the node operator). In the latter case, one need not own or operate hardware to participate and earn rewards.

Here's the source of confusion or the expectations gap: Some investors assume that these activities generate "portfolio" income for funds and their investors. But that is not accurate.

In [Notice 2014-21](#), the IRS clarified that when a taxpayer successfully mines a virtual currency, they must include the fair market value of the virtual currency reward, as of the date of receipt, in their gross income as an ordinary trade or business income. The IRS has, as of yet, not released guidance on staking. Consequently, at the moment, most in the industry are treating staking rewards similarly to mining.

Additionally, mining and staking activities can/could be interpreted as a service to the blockchain network or its participants. They would then be subject to sourcing rules—that is, the place/country in which the activity on the network is taking place.



WHAT ARE THE IMPLICATIONS?

- If an operator/fund performs/benefits from these activities in the United States, yet has foreign partners/investors, the income generated on their behalf could be deemed ECI and/or Unrelated Business Taxable Income (UBTI) and may be sourced to specific states.
 - To preempt such a possibility, consider offshore operations to avoid ECI withholding for foreign partners.
 - Rely on a non-US third-party staking service to validate nodes so as to avoid ECI withholding.
- Even if these activities take place outside the United States, they may still be considered UBTI. To address that outcome and allay the concerns of UBTI-sensitive investors, funds may need to set up a "blocker entity" within their structure to serve as an intermediary for paying those taxes on behalf of foreign partners/investors.
- If using a staking as a service provider in either a PoS or delegated-PoS protocol, it is important to understand not only where the service provider's nodes are hosted but also where its supporting workforce and operations are located. That will enable you to determine the appropriate sourcing of the income generated.

Decentralized finance (DeFi)

So, where's the expectation gap? Many assume that DeFi transactions are only taxable at the end of the transaction and/or execution of the contract. But that may not be true.

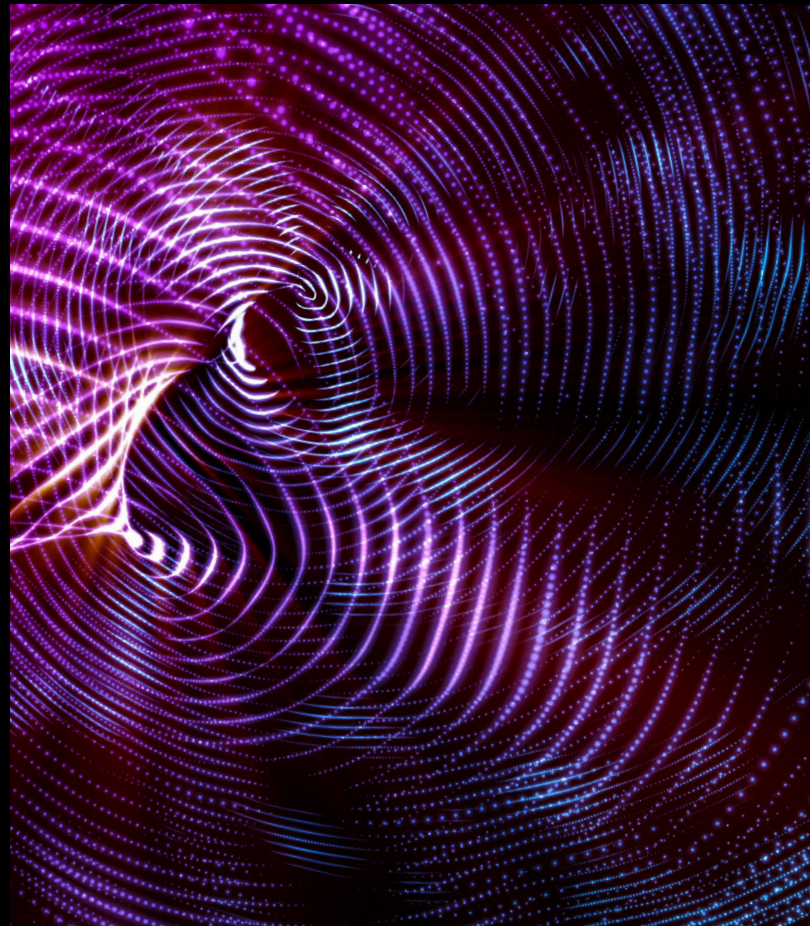
DeFi is best understood as decentralized protocols, built on the application layer of a blockchain, that facilitate the engagement of previously unrelated parties in various financial products without relying on conventional intermediaries. DeFi thereby elevates blockchain from a system for simply transferring value to one for creating value. DeFi represents a new frontier in its own right in that it has created new ways of executing contracts using a variety of different protocols.

Note: The lending of digital assets has its own set of challenges, as there is uncertainty as to whether these transactions are taxable events. Great care should be taken to ensure that execution and documentation are performed in a very precise manner and provide the best facts for non-taxable treatment. This is an extremely complex area that requires thorough consultation with an experienced tax adviser.



WHAT ARE THE IMPLICATIONS?

- Since the protocols differ depending on the type of transaction, it is imperative that funds carefully examine the character, timing, and source of their DeFi returns, as well as the fundamental nature of the transaction.
- Be sure to fully understand the functioning of the protocols that support your fund's DeFi activities and transactions, including the necessary cryptocurrencies, and most importantly their potential tax consequences.
 - Note that the use of a digital asset in a DeFi platform may, in itself, be treated as a taxable exchange.
 - One differentiating factor between DeFi platforms and centralized exchange and lending platforms is the lack of legal agreements. As a result, understanding how the platforms function is key to determining the tax implications of participation.
- Transacting on DeFi platforms domestically may generate ECI.



Forks and token upgrades

Once again, there's an expectation gap: Some funds and investors assume that forks and token upgrades are non-taxable events. However, not all forks are created equal or result in a fund acquiring new cryptocurrency. So, what matters here is the question of dominion and control over the new crypto asset.

1 [IRS Rev. Rul. 2019-24](#) provides some clarification on the tax consequences of a "hard fork" (per the IRS, "a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger"). As a result of such a fork, funds/taxpayers may find themselves holding two virtual currencies—one rooted in their ownership of the cryptocurrency tied to the legacy blockchain ledger, and the second based on a new asset tied to the new blockchain ledger.

2 Rul. 2019-24 also provides that the taxpayer will recognize income at the fair market value of the new currency ("Crypto S") as of the date on which the taxpayer exerts, per the IRS, "dominion and control of Crypto S at the time of the airdrop, when it is recorded on the distributed ledger, because B [the taxpayer] immediately has the ability to dispose of Crypto S."



WHAT ARE THE IMPLICATIONS?

- In some instances, the host may hold the new currency in a wallet for a time before transferring ("airdropping") it to the taxpayer. That is why date of dominion and control is key.
- On the other hand, according to the IRS: "A taxpayer does not have gross income under § 61, as a result of a hard fork of a cryptocurrency the taxpayer owns, if the taxpayer does not receive units of a new cryptocurrency."
- Therefore, hard forks only have tax implications if new currency is acquired.

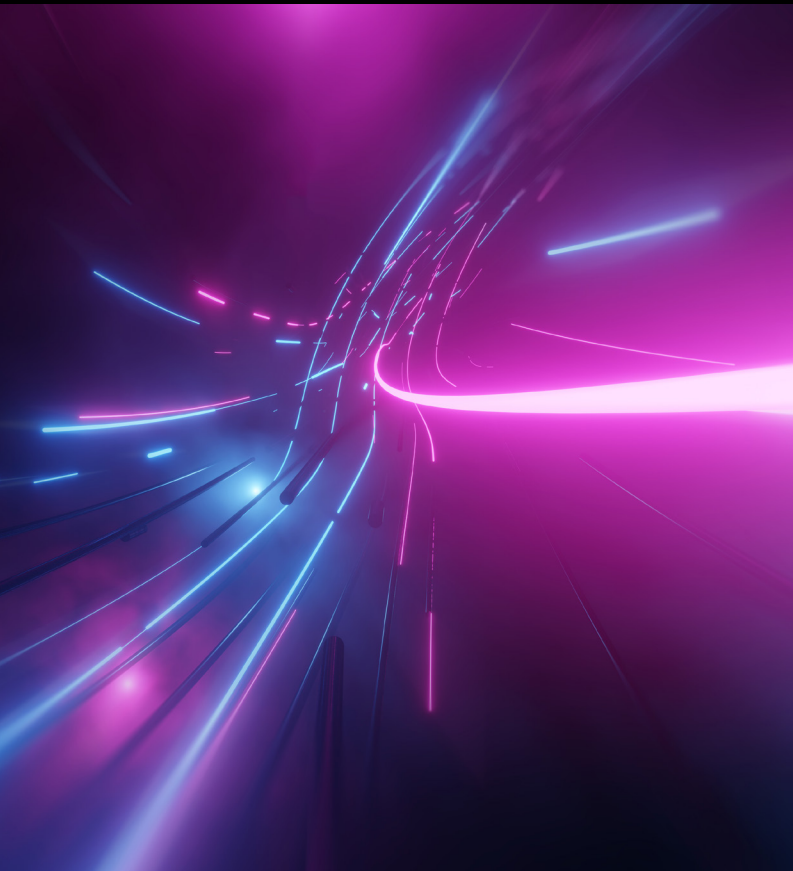
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Rul. 2019-24 also furnishes further guidance regarding upgrades to a blockchain crypto protocol (i.e., "token upgrade," aka "soft fork"). These typically do not result in taxable income.



WHAT ARE THE IMPLICATIONS?

- Some protocol upgrades require that token holders exchange the legacy token for a new token. That may result in a taxable event.
- That's why it is vital that funds and investors review the facts and circumstances attending a token upgrade to determine if it triggers a tax event for them.



Other accounting and financial reporting considerations

Similar to the tax topics discussed above, many of the same considerations apply to accounting and financial reporting under US GAAP.

- Asset managers generally apply specified Investment Company guidance in accounting for all assets, inclusive of crypto investments, under *ASC 946 Financial Services – Investment Companies*, which requires assets to be accounted for at fair value.
- Additional considerations may be necessary when applying the fair value principles in *ASC 820 Fair Value Measurements* to crypto investments. Asset managers should consider interpretive guidance in the [Accounting for and auditing digital assets AICPA practice aid](#).
- Given the varied rights and obligations afforded to participation in staking, varied DeFi protocols, and blockchain forks, careful considerations should be given to revenue recognition for these activities, including the disclosure of investments in both the Schedule of Investments and Footnotes to the financial statements.
- In addition, in situations where the entity is not regulated under the Investment Company Act of 1940, the nature of these activities should be evaluated in the context of the entity's activities to determine whether it meets the definition of an investment company within the scope of ASC 946. Entities not in the scope of ASC 946 may have significantly different accounting and reporting for their crypto investments.



Conclusion

While the complexity of the terrain and the uncertainty of the tax rules governing digital and crypto assets may seem daunting, the volume of activity in this space belies the hope of some that this, too, will pass. Crypto is here to stay. But as with the settlement of all frontiers, caution and care are in order. Analogies based on past tax experiences or apparent similarities of tax circumstances do not necessarily constitute firm ground for decision-making.

Of course, as time passes, the map of the frontier will become clearer with tax guidance emerging through new rules or lessons learned under exam. In the meantime, it is best to seek counsel and advice from recognized tax and legal advisers to help your fund and investment team develop the appropriate protocols and processes to document, and ultimately support, the tax treatment.

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Endnotes

1. The term "investing" has technical significance under the US Tax Code and regulations apart from proprietary trading and dealing in property for and with customers. For purposes of this publication, the term "investing" is used broadly in its colloquial sense to describe mere expending of capital and assuming risk on crypto unless specifically discussed otherwise for any technical distinctions in trading or dealing.



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