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Cryptocurrencies and Investment Funds – Tax Uncertainty Abounds

Cryptocurrencies are known for their extreme value swings—as of early July 2018, Bitcoin's value hovers around $6,500 per coin, down from an all-time peak of $19,343 just seven months earlier. While Bitcoin and Ether are the two most well-known cryptocurrencies, there are thousands of different types with new ones seemingly created daily. Transactions in cryptocurrencies such as Bitcoin are verified, processed, and tracked using technology known as "blockchain," which serves as a peer-to-peer recording database. Some retailers accept Bitcoin and other cryptocurrencies as a form of payment for their goods and services, but the majority of cryptocurrency transactions appear to be for speculative purposes.

Although not fully anonymous, blockchain technology makes it relatively difficult to trace cryptocurrency transactions back to specific users. While no one can be certain which exact characteristics may entice a particular investor to acquire a cryptocurrency, it is at least plausible that their potential anonymity may be viewed by some as a feature rather than a bug, providing greater areas of opportunity for their use than their more traceable counterparts. Worried that one such greater use might be for tax avoidance, the IRS issued Notice 2014-21 to remind the cryptocurrency community of its general position that cryptocurrency transactions are taxable transactions and to address certain other tax aspects. The 2014 Notice sets out the IRS's view that for federal tax purposes, "convertible virtual currencies" (which the IRS defines to embody cryptocurrencies, such as Bitcoin) are treated as "property," subject to general tax principles that apply to transactions in property and not to certain special tax rules that characterize gains and losses for transactions in currencies. The 2014 Notice also explains how to determine the fair market value of virtual currencies and illustrates how transactions are treated under certain specific tax regimes, such as the rules that apply to income from self-employment and the information reporting rules. However, the 2014 Notice leaves other important questions unanswered.

Since the 2014 Notice, the IRS has heightened its enforcement of cryptocurrency transactions without issuing any additional guidance. On July 2, 2018, the IRS announced five new compliance campaigns to be carried out by its Large Business and International Division, one of which will address noncompliance with tax laws relating to the use of virtual currencies. This announcement also indicated that the IRS is working on additional cryptocurrency guidance but stated it is not contemplating a voluntary disclosure program to address cryptocurrency tax noncompliance.

Rising investor demand for cryptocurrencies has led to the establishment of various funds to acquire cryptocurrencies and their derivatives. For foreign investors especially, the stakes are high for the tax characterization of cryptocurrencies—depending on their characterization, cryptocurrency gains may be subject to significant U.S. federal and state income taxes, or none at all. Although many tax rules must be considered in developing a tax-efficient investment structure for a cryptocurrency fund, two are especially important and both depend on the as-yet-uncertain determination of whether cryptocurrencies constitute "commodities" under their separate regimes.

For many funds seeking to be treated as partnerships for tax purposes and avoid an entity-level tax, it is often critical to ensure that such funds avoid publicly traded partnership (PTP) status. Under the applicable rules, the income and gains of a publicly traded partnership will not be taxable at corporate rates if at least 90 percent of its gross income during the taxable year consists of "qualifying income," which includes income and gains from commodities, and futures, forwards, and options on commodities. The Commodity Futures Trading Commission (CFTC) considers Bitcoin and other virtual currencies as commodities and their derivatives as subject to its regulatory jurisdiction. However, the IRS has not made explicit its views on whether a fund that primarily trades in cryptocurrencies and their derivatives can avail itself of this PTP "qualifying income" exception.

A second critical factor for a cryptocurrency fund seeking tax efficiencies for its foreign investors is whether its income and gains will be considered U.S.-source income "effectively connected" with the conduct of a U.S. trade or business (and therefore taxable for its foreign investors). The U.S. Internal Revenue Code contains certain exceptions for income and gains derived from trading in securities or commodities and their derivatives (the "trading safe harbors"). However, these trading safe harbors only apply to transactions involving commodities "of a kind customarily dealt in on an organized commodity exchange" and when such transaction is "of a kind customarily consummated at such place."

As with the determination of whether a cryptocurrency is a commodity for the PTP qualifying income exception, it is similarly unclear whether cryptocurrencies and their derivatives qualify as commodities for purposes of the trading safe harbors. Further, even if one assumes that a virtual currency is a "commodity" under the trading safe harbors, it remains unclear whether the virtual currency would be considered "of a kind customarily dealt in on an organized commodity exchange." Certain virtual currency derivative contracts are currently traded on CFTC-registered exchanges, and so trades in those derivatives could conceivably qualify under this language; however, this line of argument is less compelling for virtual currencies that are not currently traded on a CFTC-registered exchange (although, depending on the instrument at issue, one might still argue that the virtual currency is sufficiently similar to an exchange-traded variety to be "of a kind" that should equally be within this tax statutory language).

Investment funds can offer investors an easy and attractive avenue to access the exciting and evolving world of cryptocurrencies. However, investors should be aware that the various tax rules that may (or may not) apply to this relatively new asset class are exciting and evolving as well.

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