Why Buying a Sandwich with Bitcoin is a Taxable Transaction

and Other Tax Issues Affecting Funds Investing in Cryptocurrencies

By Robert Elwood

Due to their impressive returns, cryptocurrencies can be an attractive asset class. But those returns do come at a price in the form of legal restrictions and complicated tax issues for both individual and institutional investors, especially for mutual funds. When advising clients on investing in cryptocurrencies, it is essential that all parties understand the meaningful risks and reporting involved.

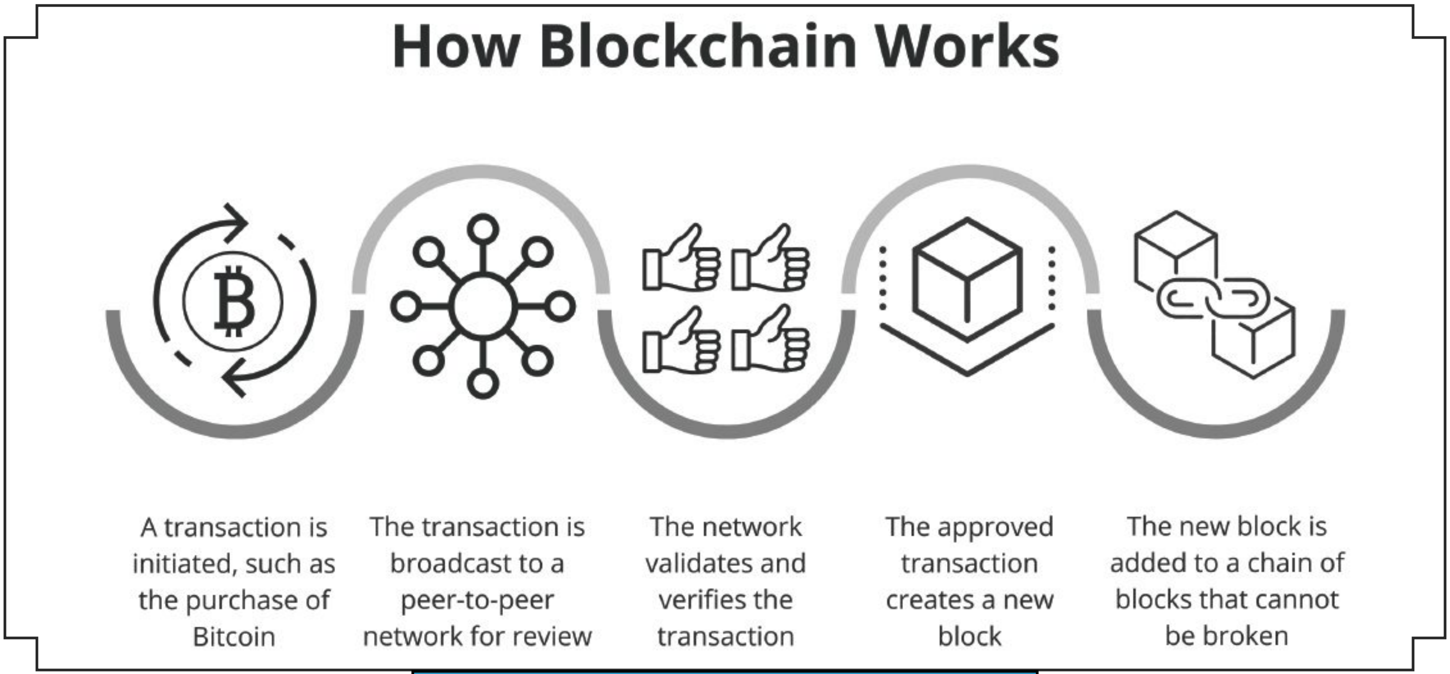
On January 1, 2017, bitcoin traded at $963. By December of that year, that number had skyrocketed to $16,601, resulting in an annual return of 1,700%. In 2019, bitcoin appreciated 92%—another impressive year. It's not surprising, then, that individual investors, mutual funds, and hedge funds are paying attention to bitcoin, Ethereum, XRP, and other digital currencies or altcoins ("cryptocurrencies").

A cryptocurrency is a medium of exchange, just as the U.S. dollar is, that is designed for the purpose of exchanging value digitally using certain principles of cryptography. Cryptography is used to secure the transactions and to control the creation of new "coins," although most cryptocurrencies are designed to decrease in production over time, which creates a ceiling on the quantity. That's different from typical government currencies where governments can always create more.

Cryptocurrency works through distributed ledger technology, typically a "blockchain" that serves as a secure, public financial transaction database.

A blockchain is a continuously growing list of records, called blocks, which are linked and secured. Each block contains a link to the previous block, a timestamp, and data detailing the transaction. These features make blockchains inherently resistant to modification of the data, which is critical given there have been many attempts to illegally obtain digital currencies.

Cryptocurrencies are legal in most countries, with some notable exceptions: Iceland, mainly due to its freeze on foreign exchange in general; Vietnam; China, which has banned financial institutions from handling cryptocurrencies;



Infographic by Weiswood Strategies Ltd.

and Russia, which has made it illegal to purchase goods with any currency other than Russian rubles. Unlike centralized banking, where governments control the value of a currency through the process of printing money, no government has direct control over cryptocurrencies as they are fully decentralized. In the U.S., however, there is oversight by both the Financial Crimes Enforcement Network (FinCEN) and the Internal Revenue Service (IRS). FinCEN has issued guidelines for cryptocurrencies, stating: "A person that creates units of convertible virtual currency and sells those units to another person for real currency or its equivalent is engaged in transmission to another location and is a money transmitter."

The IRS has ruled that cryptocurrency is to be treated not as currency but as property for tax purposes, making it subject to tax rules that apply generally to property transactions. In other words, the IRS is treating the income or gains from the sale of a virtual currency, such as bitcoin, as a capital asset, subject to either short-term (ordinary income tax rates) or long term capital gain tax rates, if the asset is held greater than 12 months (15% or 20% tax rates based on income).

This ruling imposes extensive record-keeping requirements, including tracking each purchase (tax basis), the amount realized on each sale or other disposition, tax lots, and gain or loss on each sale (not aggregate). The IRS is making tax enforcement of cryptocurrencies a high priority. On November 29, 2017, a federal court in San Francisco ordered digital currency exchange Coinbase to release certain customer information to the IRS. See *United States v. Coinbase, Inc*., 2017 WL 5890053 (N.D. Cal. 2017). The court ruled that Coinbase must turn over the details of all its bitcoin customers who had transactions greater than $20,000 between 2013 and 2015. The result of the court's order is that Coinbase had to provide information for millions of transactions made by nearly 15,000 customers.

The stakes are high for taxpayers who do not follow the rules, including penalties for civil fraud (75% of tax due), failure to file (up to 25% of tax due), failure to report foreign bank and financial accounts ($10,000 minimum), and even criminal fraud. With such steep penalties, transactions should be undertaken only when the record-keeping burden is worthwhile. In other words, don't buy a sandwich with bitcoins! Although this may change if Congress enacts the Virtual Currency Tax Fairness Act of 2020. The bill provides that U.S. federal income tax is due on gains in cryptocurrencies only if the gain on a particular transaction is greater than $200. Accordingly, if the bill passes, it would alleviate the "sandwich" problem.

Regardless of the outcome of the pending legislation, cryptocurrencies can be useful for investing purposes; although, some types of investment funds can do so more nimbly than others.

Mutual funds face the most obstacles in investing in cryptocurrencies. The Securities and Exchange Commission (SEC) has rejected various proposals to create mutual funds or exchange-traded funds (ETFs) that invest directly in cryptocurrencies. The SEC said "its disapproval does not rest on an evaluation of whether bitcoin or blockchain technology more generally, has utility or value as an innovation or an investment," but rather that the funds proposing to invest directly in cryptocurrencies "[had] not met their burden under the Exchange Act and the SEC's Rules of Practice to demonstrate that the proposals are consistent with the requirements of Exchange Act Section 6(b)(5), and, in particular, the requirement that the rules of a national securities exchange be 'designed to prevent fraudulent and manipulative acts and practices.'"

In December, the SEC seemed to give the green light to an ETF that plans to invest solely in bitcoin futures. The NYDIG Bitcoin Strategy Fund, a portfolio fund in the Stone Ridge Trust VI, appears to have received its approval based upon its plan to invest solely in cash-settled bitcoin futures contracts traded on exchanges registered with the Commodity Futures Trading Commission (CFTC). The fund does not intend to invest in bitcoin directly or any other cryptocurrencies. The fund is an unlisted, closed-end, interval fund. The fund will

When a retirement account generates income or gains from the purchase and sale of cryptocurrency, the retirement account does not pay any tax on the transaction.

not offer daily redemptions nor be subject to potentially significant and unexpected liquidity demands during short periods. The fund operators have addressed the SEC's concerns regarding valuation, custody, liquidity, and efficient arbitrage mechanisms for digital asset-based funds.

There are obstacles imposed by the Internal Revenue Code as well. One of the requirements that an entity must satisfy to be treated as a regulated investment company (RIC) is a gross income test under Code Section 851(b)(2). The RIC income test provides that at least 90% of an RIC's income must be derived from a list of sources that includes dividends, interest, sale of stock or securities, and other income derived with respect to its business of investing in stock, securities, or currencies. Thus, because cryptocurrencies are considered property and not currency, they (together with all other non-qualifying income) must be less than 10% of a mutual fund's gross income.

To qualify as an RIC, at least 50 % of the entity's total assets must be in the form of cash, cash equivalents, or securities. Also, no more than 25% of the company's total assets may be invested in securities of a single issuer unless the investments are government securities or the securities of other RICs. Cryptocurrencies do not count as cash, cash equivalents, or securities, so cryptocurrencies are not good assets for the 50% RIC asset test.

Despite the problems associated with investing using cryptocurrencies, there are potential solutions available. Funds can limit exposure so as to comply with the income and asset tests. Funds may also invest in securities that invest in cryptocurrencies. But most derivatives based on cryptocurrencies will not help (e.g., options, swaps, and futures). Potential cryptocurrency investments that may satisfy the income or asset tests include COINXBT (Bitcoin ETN), COINETH (Ethereum ETN), Bitcoin Investment Trust GBTC, Ethereum Classic Investment Trust, Z-Cash Investment Trust, Vontobel-issued certificate linked to bitcoin, and Leonteq-issued certificate linked to bitcoin.

For both hedge funds and separately managed accounts, there is no income or asset test. However, investors must keep track of each purchase, amount realized, and tax lots, as well as calculate gain or loss on each sale (not aggregate).

In addition, hedge funds, separately managed accounts, and other investors need to pay attention to the unrelated business income tax (UBIT). This is a tax on unrelated business income, which comes from an activity engaged in by a tax-exempt organization that is not related to the tax-exempt purpose of that organization. The consensus appears to be that trading in cryptocurrencies will not generally produce UBIT.

Fortunately, the rules do provide a favorable tax environment for retirement account investors. When a retirement account generates income or gains from the purchase and sale of cryptocurrency, the retirement account does not pay any tax on the transaction. Any tax would be deferred to the future when the retirement account holder takes a distribution. In the case of a Roth IRA or Roth 401(k) plan, no tax would be due if the distribution is qualified. Hence, using retirement funds to invest in cryptocurrencies could allow the investor to defer or even eliminate (in the case of a Roth) any tax due from the investment. Note, though, that retirement account investors interested in investing in cryptocurrencies do need to be aware of UBIT.

While there are some challenges associated with investing with cryptocurrencies, investors can take advantage of them provided they are fully aware of the rules and requirements at the outset. ■

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