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Year-End Tax Topics for Cryptocurrency Investors

October 20, 2021

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Now is the time for investors in cryptocurrencies to recognize approaching year-end considerations and possible planning opportunities. Potential legislative developments that might affect cryptocurrency transactions and the cryptocurrency ecosystem more broadly should also be considered.

Classification of Cryptocurrencies

Background – Cryptocurrencies as Property

Bitcoin, ether, and other cryptocurrencies are essentially digital or virtual currencies that function as a medium of exchange, a unit of account, and/or a store of value. They are all decentralized in the sense that they function by using a "peer-to-peer" model without the need for a central authority or bank. Instead, these cryptocurrencies utilize cryptography to secure and record transactions on a distributed ledger system, i.e., a blockchain. Units of cryptocurrencies are often referred to using different terms, such as coins or tokens.

The proper U.S. federal income tax treatment of transactions involving a given cryptocurrency, as is the case with financial instruments generally, depends on tax classification. And on this front, the IRS has taken the view that cryptocurrencies are to be treated as "property" (and not currency) for U.S. federal

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income tax purposes.[1] Accordingly, the tax rules applicable to property transactions (and not those concerning currencies) apply in the cryptocurrency context. Therefore, one can have a taxable event (and corresponding gain or loss) upon a sale or exchange, or by earning or even spending, a given cryptocurrency.

However, IRS guidance to date does not address what *kind* of property is involved. In some rare instances a given cryptocurrency could be treated as debt instrument[2] or equity.[3] In other cases, the cryptocurrency could be part of a financial derivative. And, depending on the context, could a given cryptocurrency be classified as a commodity, a security, or something else?

Do the investment company rules in section 721(b)[4] and section 351(e), the mark-to-market regime of section 475, the trading safe harbor in section 864(b), the securities lending rules in section 1058, the wash sale rules in section 1091, and the "qualifying income" rules for publicly traded partnership rules in section 7704(d) apply with respect to cryptocurrencies? The answer often depends on whether a given cryptocurrency can be classified as either a security or a commodity for these purposes.

Cryptocurrencies as Securities

The Code unfortunately does not contain a uniform definition of "securities." However, in many instances the definition of a "security" is limited to either stock or debt, and derivatives thereon,[5] meaning that most cryptocurrencies would not constitute "securities" for purposes of the Code provisions referenced above. It should be noted that while some cryptocurrencies may be classified as "securities" for U.S. federal securities law purposes,[6] this classification generally is not controlling for U.S. federal income tax purposes.

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[1] *See* Notice 2014-21, 2014-16 I.R.B. 938; and IRS, Frequently Asked Questions on Virtual Currency Transactions, https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions. Technically, the IRS guidance applies only to virtual currencies that are "convertible," i.e., have an equivalent value in real currency or that act as a substitute for real currency.

[2] For example, if there is an unconditional obligation to pay a sum certain at a fixed maturity date, with the ability to enforce payment (i.e., creditor remedies), it may be possible to characterize a given transaction as a loan or debt.

[3] For example, with certain initial coin offerings or ICOs, the issued/sold coins represent an equity ownership interest in the issuing entity. In other cases, a coin or token may represent tax ownership of the underlying property; that is, blockchain technology is simply used to enable, track and transfer of ownership of a given asset, such that the coin or token in question is not really a cryptocurrency like bitcoin or ether. One example in this regard is the non-fungible token, or NFT.

[4] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[5] *See, e.g.,* sections 165, 351, 354, 368, 475, and 731.

[6] *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

Cryptocurrencies as Commodities

As with the term "securities," the Code likewise does not contain a uniform definition of "commodities." In fact, in some instances the definition is circular.[7] That being said, while most cryptocurrencies are unlikely to be classified as securities, certainly some cryptocurrencies *can be* classified as commodities.

The Commodities Future Trading Commission (the "CFTC") views bitcoin and ether as commodities, and historically the IRS has given some deference to the CFTC's views as to what constitutes a "commodity" for U.S. federal income tax purposes.[8] In addition, for tax purposes it seems as if one can rely on the ordinary and common meaning of the term "commodity" from a financial point of view, which suggests that one should determine whether the item in question is traded in and listed on a commodities exchange. There is actual trading on both bitcoin and ether, as well as futures and derivatives thereon, on the Chicago Mercantile Exchange ("CME"). Accordingly, while not entirely clear, it appears that both bitcoin and ether likely constitute commodities. Whether cryptocurrencies other than bitcoin and ether also can be classified as commodities may be less clear.

It should be noted that for purposes of the commodities trading safe-harbor in section 864(b), however, not only must the cryptocurrency in question be properly classified as a "commodity," but it also must be of a kind customarily dealt in on an "organized commodity exchange" and the transaction must be "of a kind customarily consummated at such place." The applicable regulations exclude goods or merchandise in the ordinary channels of commerce from the term "commodities." Open questions in this regard therefore include: Do only *futures* on bitcoin or ether qualify? Do exchanges other than the CME (such as Coinbase) constitute an "organized commodity exchange"?

Whether any given cryptocurrency constitutes a "commodity" is highly fact dependent and may depend on the particular Code provision involved. As more cryptocurrencies have derivatives that are actually traded on an exchange, the more likely they can be classified as commodities. Given these uncertainties, it would be prudent for investors to discuss the issue with their own tax advisers.

Cryptocurrencies as Money or Currency

Again, the IRS is of the view that cryptocurrency is to be classified as property and not as money or currency (legal tender). At the time the IRS stated this view in 2014, however, no cryptocurrency had been adopted as "legal tender" in any jurisdiction, a point explicitly noted by the IRS in its guidance.

However, El Salvador recently adopted bitcoin as legal tender, and China developed its own cryptocurrency for internal use, the yuan. Unanswered questions remain whether bitcoin and perhaps other cryptocurrencies could perhaps now be classified as currency or foreign currency.

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[7] One example of a circular definition is that set forth in section 475, which states that for purposes of sections 475(e) and (f), the term "commodity" is defined to include any commodity which is actively traded (within the meaning of section 1092(d)(1)).

[8] *See* Rev. Rul. 73-58, 1973-1 C.B. 337 ("The word 'commodities' is used in section 864(b)(2)(B) of the Code in its ordinary financial sense and includes all products that are traded in and listed on commodity exchanges located in the United States. Furthermore, the word 'commodities' includes the actual commodity and commodity futures contracts.").

Specific Lot Identification

For taxpayers holding multiple units of a cryptocurrency with different bases and/or holding periods, the tax consequences of a sale, exchange, or other disposition can vary, in some cases quite dramatically, depending on the unit of cryptocurrency sold. To illustrate: assume a taxpayer purchased one bitcoin in 2014 for $300 and one bitcoin in 2021 for $64,000. The taxpayer sells one bitcoin later in 2021 for $40,000. The taxpayer will realize a $39,700 ($40,000 amount realized - $300 basis) long-term capital gain or a $24,000 ($40,000 amount realized - $64,000 basis) short-term capital loss, depending on which bitcoin is sold.[9]

The IRS indicated in frequently asked questions ("FAQs") that taxpayers owning multiple units of cryptocurrency with different bases or holding periods may choose the units that are deemed to be sold, exchanged, or otherwise disposed of if they specifically identify which unit or units of cryptocurrency are involved in the transaction and substantiate their basis in those units.[10] If a taxpayer chooses to specifically identify the units of cryptocurrency sold, the FAQs indicate that a taxpayer may do so by documenting the specific unit's unique digital identifier or by records showing the transaction information for all units of a specific cryptocurrency held in a single account, wallet, or address.[11] This information must show:

— The date and time each unit was acquired

— The taxpayer's basis and the fair market value of each unit at the time it was acquired

— The date and time each unit was sold, exchanged, or otherwise disposed of, and

— The fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit[12]

If a taxpayer does not specifically identify the specific units of virtual currency that are sold, exchanged, or otherwise disposed of, the FAQs indicate that the units are deemed to be sold in chronological order beginning with the earliest unit of the cryptocurrency purchased or acquired—that is, on a first in, first out ("FIFO") basis.[13] As a best practice, taxpayers should retain a standing lot relief methodology that can be overridden on a one-off basis if desired. A written standing methodology ensures that the taxpayer's intent is clear, and that the units being sold are identified before the disposition occurred.[14]

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9 This example and the discussion that follows assumes that the cryptocurrencies are capital assets in the hands of the taxpayer.

10 *See* IRS, Frequently Asked Questions on Virtual Currency Transactions, Q/A 39, https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.

11 *See* IRS, Frequently Asked Questions on Virtual Currency Transactions, Q/A 40, https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.

12 *Id.*

13 *See* IRS, Frequently Asked Questions on Virtual Currency Transactions, Q/A 41, https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.

14 *Cf.* regulation section 1.1012-1(c)(8) ("[A]n adequate identification of stock is made at the time of sale, transfer, delivery, or distribution if the identification is made no later than the earlier of the settlement date or the time for settlement required by

Although helpful, it is worth noting that the FAQs are not binding on the IRS.[15] However, the specific identification and FIFO rules outlined in the FAQs are very similar to the specific identification rules for stock and securities, which have also been applied by analogy in the commodity context.[16] As described above, it is possible (and perhaps likely) that (at least some) cryptocurrencies should be characterized as commodities for U.S. federal income tax purposes. Therefore, there may be some level of precedential support for applying the approach described in the FAQs.

Nevertheless, taxpayers making significant investments in cryptocurrencies might consider other potential approaches to determining the tax basis for cryptocurrency sold and best practices to ensure the tax results of their cryptocurrency transactions align with their expectations.

One potential alterative approach would be to determine the basis of the units sold, exchanged, or otherwise disposed of by viewing the blockchain, determining the actual unit sold, and then determining the cost basis of that particular unit.[17] For example, Bitcoin uses an unspent transaction output ("UTXO") model, whereby individual UTXOs of bitcoin may be tracked across the Bitcoin blockchain. Thus, upon disposing of a UTXO, the taxpayer could use the basis of that particular UTXO to determine the gain or loss on the transaction. This approach could be administratively burdensome and would be disadvantageous from a tax planning standpoint because taxpayers typically do not have the ability to control which unit of cryptocurrency is actually sold.[18] It may also not be possible to apply this approach to all cryptocurrencies, particularly cryptocurrencies for which individual units cannot be tracked.

Another potential alternative would be to apply foreign currency rules. Under those rules, the basis of the currency withdrawn from an account is determined under any reasonable method that is consistently applied.[19] The foreign currency regulations provide that FIFO, last-in-first-out ("LIFO"), and pro-rata lot relief methodologies are reasonable; but, a methodology under which the units with the

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Rule 15c6–1 under the Securities Exchange Act of 1934, 17 CFR 240.15c6–1 (or its successor). A standing order or instruction for the specific identification of stock is treated as an adequate identification made at the time of sale, transfer, delivery, or distribution.").

15 The FAQs are not authoritative because they were not published in the Internal Revenue Bulletin. However, a Government Accountability Office report on the FAQs recommended that the Commissioner of Internal Revenue should update the FAQs to include a statement that the FAQs may serve as a source of general information but cannot be relied upon by taxpayers as authoritative given that they are not binding on IRS. The IRS disagreed with this recommendation and, in an August 2020 letter, stated that the "FAQs are illustrative of how longstanding tax principles apply to property transactions." The IRS also stated that they the "IRS does not take positions contrary to public FAQs." *See* GAO, Virtual Currencies: Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance, GAO-20-188 (Feb. 12, 2020), https://www.gao.gov/products/gao-20-188.

16 *See* regulation section 1.1012-1(c); Perlin v. Commissioner, 86 T.C. 388 (1986).

17 *See* section 1012(a).

18 In the case of a hosted wallet, taxpayers generally do not have direct control of their cryptocurrencies because the cryptocurrencies are held by a custodian that stores them on behalf of their beneficial owners, similar to a traditional stock or securities brokerage account. In the case of a non-hosted wallet, the taxpayer will have direct control over their cryptocurrency, but will generally not be able to select the specific units sold because most wallet software uses an algorithm to select the units disposed of.

19 Regulation section 1.988-2(a)(2)(iii)(B)(1).

highest basis are consistently withdrawn first is not reasonable.[20] Again, from a tax planning standpoint this approach would be disadvantageous because taxpayers would not be allowed to use a highest-in-first-out ("HIFO") lot relief methodology to minimize gains and maximize losses. The foreign currency approach is arguably contrary to the IRS's position that cryptocurrencies are not currencies.[21] However, it is possible that the IRS could nevertheless attempt to apply these rules by analogy or, in the case of bitcoin, argue that the rules directly apply because bitcoin is a foreign currency (see discussion above).

Where does this leave us? At a minimum, taxpayers should maintain detailed records to comply with the information requirements described in the FAQs and create a written standing lot relief methodology (e.g., HIFO, LIFO, etc.) that should be maintained in their books and records and supplied to their broker (if possible). Deviations from this standing lot relief methodology (if desired) should be documented in writing prior to the date of disposition. For taxpayers making significant investments in cryptocurrencies, it may be worth going a step further and creating separate wallets or accounts to hold each tranche of cryptocurrency purchased (this is often done with the help of a cryptocurrency exchange). By segregating cryptocurrency into tranches with a uniform basis and holding period, a taxpayer will know for certain the tax consequences of a sale because the basis and holding period of the cryptocurrency sold would be the same under any potential approach.

Lastly, we note that the treatment of many cryptocurrency transactions is currently unclear. For example, it is not entirely clear whether cryptocurrency loans or Wrapped Bitcoin minting transactions are taxable exchanges.[22] For taxpayers taking the position that these types of transactions are not taxable, specific identification of the cryptocurrency subject to these arrangements can help limit the potential downside if the IRS takes the position that the particular arrangement constitutes a taxable event.

Tax Loss Harvesting

Taxpayers have long used a strategy commonly described as "tax loss harvesting" to reduce their tax liability by triggering capital losses on depreciated positions to offset gains on other positions. In the stock and securities context, tax loss harvesting is policed by (among other things) the "wash sale rules," which disallow the loss on the sale of stock or securities if the taxpayer purchases substantially identical stock or securities within the 61-day period beginning 30 days prior to the sale date and ending 30 days after the sale date.[23] Thus, a taxpayer cannot recognize a loss while maintaining economic

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20 *Id.*

21 *See* Notice 2014-21, 2014-16 I.R.B. 938 (Q&A 1); and Rev. Rul. 2019-24, 2019-44 I.R.B. 1004.

22 For a detailed discussion of the potential arguments as to why these two types of transactions might not be taxable exchanges, see Tompkins and Raglan, *Cryptocurrency Loans—Taxable or Not?*, Journal of Taxation of Financial Products, Vol. 17, No. 1 (2020), *available at* https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/cryptocurrency-loans-taxation-jofp-q12020.pdf; and Ritter, Tompkins, and Dalbey, *Wrapped Bitcoin—Two Sides of the Same (Bit)coin?*, Journal of Taxation of Financial Products, Vol. 18, No. 2 (2021), *available at* https://tax.kpmg.us/content/dam/tax/en/pdfs/2021/bitcoin-two-sides-jofp-summer-21.pdf.

23 Section 1091(a); regulation section 1.1091-1(a).

exposure to an investment by, for example, selling depreciated stock and immediately repurchasing the same stock.

Under current law, it is not believed that the wash sale rules apply to transactions involving cryptocurrency, because most cryptocurrencies do not constitute stock or securities (as noted above). New proposed legislation would make cryptocurrency transactions subject to the wash sale rules (see discussion below). However, this legislation is currently not proposed to be effective until 2022 and again, in the absence of a statutory change, cryptocurrency transactions are widely believed to be outside the scope of the wash sale rules.[24] Thus, cryptocurrency investors seeking to harvest tax losses in 2021 have significantly more flexibility to do so than stock or securities investors.

Although the wash sale rules are probably not a barrier to tax loss harvesting in 2021, they are not the government's only weapon against attempts to generate noneconomic losses. Depending on the circumstances of a particular transaction that appears to result in a loss, the loss may also be disregarded if the transaction does not result in a "bona fide" loss, lacks economic substance, or is a sham.[25] Also, even if a loss transaction is respected, taxpayers must also be mindful of other limitations on the use of capital losses, such as the overall limitations on the use of capital losses by corporate and individual taxpayers.[26]

Legislative Proposals

Information Reporting

In August 2021, the Senate passed the Infrastructure Investment and Jobs Act (commonly referred to as the "Infrastructure Bill"). The Infrastructure Bill would authorize the IRS to issue regulations requiring brokers to report on customer sales and transfers of digital assets.[27] Moreover, the bill would classify digital assets as "covered securities" if the assets are acquired on or after January 1, 2023. "Covered securities" are subject to cost basis rules, and brokers would generally be required to report not only proceeds from the sale of these assets but also a customer's cost basis in the assets sold, along with information such as gain or loss on the sale and whether the gain or loss is long term or short term.

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[24] For a detailed discussion of the reasons why most practitioners believe the wash sale rules do not currently apply to cryptocurrencies, see Tompkins and Kunkel, *Cryptocurrencies and the Definition of a Security for Code Sec. 1091*, Journal of Taxation of Financial Products, Vol. 18, No. 2 (2021), *available at* https://tax.kpmg.us/content/dam/tax/en/pdfs/2021/cryptocurrencies-section-1091-jofp-summer-21.pdf.

[25] *See, e.g.*, Horne v. Commissioner, 5 T.C. 250 (1945) (the court determined that the wash sale rules did not apply, nevertheless denied a deduction for the purported loss on the basis that it was not "real"); Rev. Rul. 77-185, 1977-1 C.B. 48 (loss denied because there was no real change of position in a true economic sense).

[26] *See generally* section 1211. Losses in actively traded cryptocurrencies may also be deferred by the staddle rules of section 1092. A detailed discussion of these rules and the other potential limitations on the deduction of cryptocurrency losses are outside the scope of this article.

[27] The cryptocurrency tax reporting provisions amend section 6045, which currently governs broker tax reporting, such as for stocks and securities.

Digital assets for this purpose include not only traditional cryptocurrencies but also “any digital representation of value that is recorded on a cryptographically secured distributed ledger” or any similar technology as may be specified by the IRS. This, for example, might cover nonfungible tokens.

These broker tax reporting provisions raised significant concerns among a range of cryptocurrency platforms and service providers. Some were concerned that the definition of broker in the bill was unnecessarily broad as it includes “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.” Could the definition cover non-custodial participants and platforms such as validators or hardware and software wallet providers? Senate debate suggests that the intent may be somewhat narrower. The target appears to be centralized cryptocurrency exchanges, although there are also indications that Treasury is looking at including decentralized exchanges and peer-to-peer marketplaces within the scope of tax information reporting.

From an investor’s perspective, this will mean that eventually the IRS would obtain information on an investor’s sales of cryptocurrency assets and gain or loss on these sales, much as it currently does on stocks and securities. Since brokers would also be required to furnish customers with a statement of the information filed with the IRS, investors would also be expected to receive tax statements with tax information for inclusion in individual tax returns. These statements likely would be in the same format as for securities, which is currently provided on a Form 1099-B.

In the past, certain exchanges may have provided investors with a Form 1099-K to report gross sales. Presumably, this reporting would change to a Form 1099-B format, although the timing may still be unclear. Some exchanges may wait not only for final legislation but also for clear IRS regulatory guidance prior to shifting reporting processes.

However, a January 1, 2023 effective date for treating digital assets as “covered securities” may mean that systems will need to be in place prior to that date to accommodate both IRS and customer tax reporting.

A couple other provisions in the Infrastructure Bill are worth noting. First, the Infrastructure Bill would also require brokers to provide transfer statements, containing cost basis information, when digital assets are transferred to another broker or exchange or to a non-broker wallet address such as a private wallet.[28] Second, the bill would require businesses that receive digital assets in value exceeding $10,000 to report these payments. This is an amendment of an existing reporting provision[29] that was initially drafted to apply to cash payments.

Outside the Infrastructure Bill, there is a proposal by the Biden Administration to have financial institutions report on account inflows and outflows for both bank and other financial accounts as well as accounts at cryptocurrency exchanges. There is also a separate proposal for brokers to report on underlying non-U.S. owners that use certain passive entities to invest in cryptocurrency assets on an

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[28] This would be an amendment to existing section 6045A which provides for reporting on transfers between brokers. A new section 6045A(d) would require reporting for transfers of digital assets to non-broker addresses.

[29] *See* section 6050I.

exchange. The rationale behind the latter provision is that the IRS is seeking information on non-U.S. persons that it could exchange with tax authorities in other jurisdictions for information on U.S. persons with cryptocurrency accounts abroad.

The impact of these tax information reporting provisions on investors would likely be two-fold. One is the reduction in tax anonymity when it comes to investing in cryptocurrency assets. The second is that tax-relevant information on cryptocurrency asset transactions may become more readily available for investors as brokers and cryptocurrency-asset platforms begin to implement some of these tax information reporting rules. But again, these provisions are not yet law, and it is presently unclear whether these proposals will be passed by Congress in their present form (if at all). Nonetheless, it seems as if increased tax reporting for cryptocurrencies will come eventually, with or without this legislation.[30]

Wash Sale Rules

As described above, the wash sale rules generally apply to disallow a loss (or, more accurately, generally defer or postpone the loss) on the sale of a stock or security if the taxpayer acquires substantially identical stock or securities, or enters into a contract or option to acquire substantially identical stock or securities, within a 61-day period starting 30 days before the sale date. For this purpose, the term "stock or securities" generally includes contracts or options to acquire or sell stock or securities.[31]

The wash sale rules also have special basis and holding period rules. Specifically, the basis of the acquired stock or securities that resulted in denial of the loss from the sale or other disposition of substantially identical stock or securities is increased by the amount of disallowed loss.[32] Just as the basis of the old stock or securities is preserved under the wash sale rules, the holding period of the old stock or securities also "tacks" onto the holding period of the new stock or securities. Thus, the holding period for the new stock or securities acquired is adjusted to include the holding period for the stock or securities that was sold at a loss.[33]

Again, under current law it is not believed that the wash sale rules apply to transactions involving cryptocurrency, as most cryptocurrencies do not constitute stock or securities (as defined), However, the Build Back Better Tax Act, approved by the House Committee on Ways and Means Committee on September 15, 2021 (the "proposed legislation"), includes a significant expansion of the wash sale rules and constructive sale rules (described below), which expansion could capture cryptocurrencies. In particular, with respect to the wash sale rules, the proposed legislation would modify those rules to apply to a loss claimed with respect to any sale or other disposition of a "specified asset." Under the proposed legislation, a specified asset would include (1) any share of stock in a corporation;
(2) any partnership or beneficial ownership interest in a widely held or publicly traded partnership or

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[30] The IRS priority guidance plan included regulations regarding information reporting on virtual currency under section 6045 even prior to the Infrastructure Bill proposal.

[31] Section 1091(a); regulation section 1.1091-1(a).

[32] Section 1091(d); regulation section 1.1091-2(a).

[33] Section 1223(3); regulation section 1.1223-1(d).

trust; (3) any note, bond, debenture, or other evidence of indebtedness; (4) any foreign currency; (5) any commodity which is actively traded; (6) any interest rate, currency, equity, or actively traded commodity notional principal contract; (7) any evidence of an interest in, or a derivative financial instrument in, any of the foregoing, including any option, forward contract, futures contract, short position, and any similar financial instrument in such a security, actively traded commodity, or currency; and (8) *any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.* Except as provided in regulations, a specified asset would also include contracts or options to acquire or sell any specified assets.

Although the term “stock or securities” is not defined in the Code or the regulations for purposes of the wash sale rules, it has generally been interpreted to exclude foreign currency, commodities, commodities derivatives, and cryptocurrencies. By replacing “stock or securities” with “specified asset” Congress would greatly expand the scope of the wash sale rules, especially as applied to cryptocurrencies.

The proposed legislation would also modify the wash sale rules to disallow losses if a related party has acquired a replacement position. For this purpose, a related party would be broadly defined to include the taxpayer’s spouse, dependents of the taxpayer, persons to whom the taxpayer is a dependent, and a wide variety of entities (e.g., a corporation controlled by the taxpayer) and tax-advantaged plans (e.g., IRAs and section 529 plans) if certain requirements are satisfied. The provision would also authorize the Secretary to issue regulations or additional guidance to prevent the avoidance of the wash sale rules through the use related parties. In the case of any acquisition of substantially identical specified assets by a related party other than the taxpayer’s spouse, the basis of the substantially identical specified assets would not be adjusted to include the disallowed loss. If the substantially identical specified assets are acquired by the taxpayer or the taxpayer’s spouse during the period beginning 30 days before the sale and ending on the close of the taxpayer’s first tax year after the sale, then the basis of the acquired specified assets would be increased by the amount of the disallowed loss.

Although the IRS previously applied the wash sale rules across related parties in published guidance, many questioned the technical merits of this position. The proposed legislation would provide a statutory basis for applying the wash sale rules across the enumerated types of related parties and also grant regulatory authority to allow Treasury and the IRS to address related party situations that are not specifically covered by the proposal. The application of the wash sale rules across related parties would require adjustments to the taxpayers’ systems and processes for identifying wash sale transactions.

The related party rules are also notable in that they could transform what was generally a temporary loss deferral provision into a permanent loss disallowance rule by providing a basis adjustment only if the taxpayer or the taxpayer’s spouse acquires the replacement specified asset. It appears that this approach was chosen to limit taxpayers’ ability to use the wash sale rules to shift losses among related parties. The potential for a permanent loss disallowance would represent a significant trap for the unwary and, if enacted, taxpayers would be well advised to coordinate closely with related parties to avoid inadvertent wash sale transactions.

The proposed legislation would allow basis adjustments if the taxpayer or the taxpayer's spouse acquires substantially identical specified asset during the period beginning 30 days before the date on which the loss position was sold and ending with the close of the following tax year. It is not entirely clear why the basis adjustment window is longer than the wash sale window, but it could be intended to reduce the likelihood of permanent loss disallowance.

The proposed legislation does not modify the holding period adjustment rules to incorporate the "specified asset" language and does not indicate whether holding period adjustments will be made if a basis adjustment is not allowed. These omissions may have been inadvertent.

Importantly, the proposed legislation contains an exception for foreign currency and commodities losses that are either (1) directly related to the business needs of a trade or business of the taxpayer (other than the trade or business of trading foreign currencies or commodities); or (2) part of a hedging transaction (as defined by section 1221(b)(2)). There is not a similar exception for digital assets. Thus, to the extent digital assets are used in a trade or business, their status as a commodity or non-commodity may be important for purposes of qualifying under the commodity loss exception described above.

The proposed legislation would apply to sales and other dispositions occurring after December 31, 2021.

Constructive Sale Rules

As mentioned above, the proposed legislation would also modify the constructive sale rules of section 1259. In general, in the case of a constructive sale of an "appreciated financial position," a taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale.[34] Any gain or loss realized after the constructive sale with respect to the position is adjusted to reflect any gain taken into account as a result of the constructive sale. In addition, the holding period of the position is determined as if the position were originally acquired on the date of the constructive sale.[35] An "appreciated financial position" is, generally, any position with respect to any stock, debt instrument, or partnership interest if there would be gain were the position sold, assigned, or otherwise terminated at its fair market value. A "position" is defined as an interest, including a futures or forward contract, short sale, or option.[36]

A taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) (A) enters into a short sale of the same or substantially identical property, (B) enters into an offsetting notional principal contract with respect to the same or substantially identical property, (C) enters into a futures or forward contract to deliver the same or substantially identical property, (D) in the case of an appreciated financial position that is a short sale or a contract described in (B) or (C) with respect to any property, acquires the same or substantially identical property, or (E) to the extent prescribed by the Secretary in regulations, enters into one or more other transactions (or

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[34] Section 1259(a)(1).

[35] Section 1259(a)(2).

[36] Section 1259(b).

acquires one or more positions) that have substantially the same effect as a transaction described in any of the preceding sentence.[37]

Given the current definition of an “appreciated financial position,” it is believed that the constructive sale rules are generally not applicable to most cryptocurrencies now. However, the proposed legislation would add “digital asset” to the definition of an appreciated financial position. A digital asset for these purposes means any digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary. Thus, if enacted, a constructive sale of a digital asset would be subject to the general rule for constructive sales, so a taxpayer would have to recognize gain as if the position with respect to the digital asset were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Further, the definition of constructive sale outlined in (D) above would be expanded to include situations in which a taxpayer has an appreciated short sale, notional principal contract, forward contract, or futures contract and enters into a contract to acquire the same or substantially identical property.

This proposed expansion of the constructive sale rules will be of particular interest to taxpayers that seek to monetize their appreciated cryptocurrency positions without disposing of them. In addition, currently an appreciated short sale, short swap, or short forward or futures contract is constructively sold when the taxpayer acquires the reference property. The proposed legislation would expand this rule to trigger a constructive sale if the taxpayer “enters into a contract to acquire” the reference property such that a constructive sale could occur if a taxpayer enters into an offsetting long derivative rather than acquiring an outright position in the underlying reference property.

The proposed legislation would apply to constructive sales and contracts entered into after the date of enactment.

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[37] Section 1259(c).

