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from: Ronald J. Goldstein
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subject: Applicability of I.R.C. section 165 to cryptocurrency that has declined in value

This Chief Counsel Advice responds to your request for non-taxpayer specific advice regarding the applicability of section 165 of the Internal Revenue Code ("Code") to cryptocurrency that has substantially declined in value. This document should not be used or cited as precedent.

Issue

Section 165 of the Code provides for the deduction of losses sustained during the taxable year. If Taxpayer A owns cryptocurrency that has substantially declined in value, has Taxpayer A sustained a loss under section 165 of the Code due to worthlessness or abandonment of the cryptocurrency?

Conclusion

No. Section 165 provides a deduction for losses that are evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Taxpayer A has not abandoned or otherwise disposed of the cryptocurrency, and the cryptocurrency is not worthless because it still has value. Therefore, Taxpayer A has not sustained a loss under section 165 and the corresponding regulations. Further, even if Taxpayer A sustained a loss under section

165, the loss would be disallowed because section 67(g) suspends miscellaneous itemized deductions for taxable years 2018 through 2025.

Facts

Taxpayer A is an individual who purchased units of Cryptocurrency B in 2022 at $1.00 per unit for personal investment purposes on a cryptocurrency exchange. After Taxpayer A acquired Cryptocurrency B, the per unit value of Cryptocurrency B decreased significantly, such that each unit of Cryptocurrency B was valued at less than one cent at the end of 2022. On December 31, 2022, Cryptocurrency B continued to be traded on at least one cryptocurrency exchange, and Taxpayer A maintained dominion and control over the units of Cryptocurrency B as evidenced by Taxpayer A's ability to sell, exchange, or transfer the units. Taxpayer A claimed a deduction on Taxpayer A's 2022 tax return under section 165 and took the position that the units of Cryptocurrency B were either worthless or abandoned.

Discussion

Digital assets are defined under section 6045(g)(3)(D) as digital representations of value that are recorded on a cryptographically secured distributed ledger.[1] Digital assets do not exist in physical form and include, but are not limited to, property the Service has previously referred to as convertible virtual currency and cryptocurrency. See Notice 2014-21, 2014-16 I.R.B. 938; Rev. Rul. 2019-24, 2019-44 I.R.B. 1004. Notice 2014–21 provides that convertible virtual currency is treated as property and that general tax principles applicable to property transactions apply to convertible virtual currency.

Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Units of cryptocurrency are generally referred to as coins or tokens. Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality. See Rev. Rul. 2019-24.

Sales, exchanges, and other dispositions of digital assets may result in recognition of gain or loss. The character of a gain or loss resulting from a disposition of a cryptocurrency generally depends on whether the property is a capital asset in the hands of the taxpayer. A taxpayer not in the trade or business of dealing in cryptocurrency will generally realize capital gain or loss on the sale or exchange of a cryptocurrency. A taxpayer realizes ordinary gain or loss on the sale or exchange of property that is not held as a capital asset.

[1] The Infrastructure Investment and Jobs Act ("the Act"), Pub. L. 117-58, div. H, title VI, section 80603(b)(1)(B), added new section 6045(g)(3)(D), which uses this definition of a digital asset for purposes of information reporting by brokers effective January 1, 2023. The Act provides the Secretary with the authority to further define the term "digital asset."

Section 165(a) of the Code provides a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise. A loss is allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss is treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. Treas. Reg. section 1.165-1(d)(1).

Section 165(g) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss shall be treated as a loss from the sale or exchange of a capital asset. Section 165(g)(2) defines a security as a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form. Cryptocurrency B is none of the items listed in section 165(g)(2), and therefore section 165(g) does not apply.

For individual taxpayers, section 67(b)(3) characterizes section 165(a) losses, other than those from casualty, theft, and wagering, as miscellaneous itemized deductions.[2] Under current law, section 67(g) disallows all miscellaneous itemized deductions for tax years beginning after December 31, 2017, and before January 1, 2026.

Worthless Cryptocurrency

Cryptocurrency B has substantially decreased in value; however, its value was greater than zero, it continued to be traded on at least one cryptocurrency exchange, and A did not sell, exchange, or otherwise dispose of the units of Cryptocurrency B. "The mere diminution in value of property does not create a deductible loss. An economic loss in value of property must be determined by the permanent closing of a transaction with respect to the property. A decrease in value must be accompanied by some affirmative step that fixes the amount of the loss, such as abandonment, sale, or exchange." Lakewood Assocs. v. Commissioner, 109 T.C. 450, 459 (1997); Treas. Reg. section 1.165-1; see also Higgins v. Smith, 308 U.S. 473, 475 (1940) ("[D]eductions are permitted for losses 'sustained during the taxable year.' The loss is sustained when realized by a completed transaction determining its amount."); United States v. White Dental Mfg. Co., 274 U.S. 398, 401 (1927) ("The statute obviously does not contemplate and the regulations forbid the deduction of losses resulting from the mere fluctuation in value of property owned by the taxpayer.") (internal citation omitted).

A loss may be sustained, however, if a cryptocurrency becomes worthless, resulting in an identifiable event that occurs during the tax year for purposes of section

[2] Special rules apply to casualty, theft, and wagering losses. See sections 67(b)(3), 165(d) and (h), 1231, and Rev. Rul. 2009-9.

165(a). Whether an asset has become worthless is a question of fact. Boehm v. Commissioner, 326 U.S. 287, 293 (1945). In the case of a worthless asset, it is not necessary to relinquish title where there is a "subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is in fact essentially valueless." Echols v. Commissioner, 935 F.2d 703, 708 (5th Cir. 1991). In Morton v. Commissioner, the Board of Tax Appeals explained that "[t]he ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitively fix the loss." 38 B.T.A. 1270, 1278 (1945).

In MCM Investment Management, LLC v. Commissioner, the Tax Court applied the tests articulated in Echols and Morton to determine whether a partnership interest was worthless and allowed a claimed loss deduction under section 165. T.C. Memo. 2019-158 at *26-31, *62 (citing Echols, 935 F.2d at 708; Morton, 38 B.T.A. at 1278). The Tax Court found that the petitioner subjectively determined that its partnership interest was worthless and, to determine whether there were also objective indicia of worthlessness, examined whether the partnership interest had liquidating value or any potential future value. Id. at *28-29, *31-32. Because the petitioner could recover nothing for its partnership interest upon liquidation of the partnership and because there was no potential future value due to the third-party subordinated debt agreements at issue, the Tax Court determined that the partnership interest was worthless. Id. at *58, *62.

In this case, each unit of Cryptocurrency B had liquidating value, though it was valued at less than one cent at the end of 2022.[3] Cryptocurrency B continued to be traded on at least one cryptocurrency exchange, allowing for the possibility that it may increase in value in the future. Accordingly, Cryptocurrency B was not wholly worthless during 2022 as a result of its decline in value, and Taxpayer A did not sustain a bona fide loss under section 165(a) in 2022 due to worthlessness.

Abandoned Cryptocurrency

Under Treas. Reg. section 1.165-2(a), a taxpayer sustains a loss under section 165(a) for the obsolescence or loss of usefulness of nondepreciable property if: "(1) the loss is incurred in a business or a transaction entered for profit; (2) the loss arises from the sudden termination of usefulness in the business or transaction; and (3) the property is permanently discarded from use, or the transaction is discontinued." Franklin v. Commissioner, T.C. Memo. 2020-127 at *18 (citing Treas. Reg. section 1.165-2(a)).

[3] As of January 1, 2023, fifteen cryptocurrencies valued at less than one cent per unit were actively traded with market caps ranging from approximately $77 million to over $4.4 billion along with 24-hour trading volume ranging from $833,000 to $92 million. See www.coinmarketcap.com for cryptocurrency market values.

Taxpayer A did not take any action to abandon and permanently discard Taxpayer A's units of Cryptocurrency B during 2022. Abandonment is proven through an evaluation of the surrounding facts and circumstances, which must show: (1) an intention to abandon the property, coupled with (2) an affirmative act of abandonment. See Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220, 225 (1972) (citing Boston Elevated Railway Co. v. Commissioner, 16 T.C. 1084, 1108 (1951), aff'd, 196 F.2d 923 (1st Cir. 1952)). "The mere intention alone to abandon is not, nor is non-use alone, sufficient to accomplish abandonment." Beus v. Commissioner, 261 F.2d 176, 180 (9th Cir. 1958), aff'g 28 T.C. 1133 (1957). Some express manifestation of abandonment is required when the asset is an intangible property interest. Citron v. Commissioner, 97 T.C. 200, 209–10, 213 (1991) (finding that taxpayer abandoned a partnership interest when the limited partners voted to dissolve the partnership, directed that a final partnership return be filed, and treated partnership property as no longer belonging to the limited partners).

In this case, Taxpayer A maintained ownership of Cryptocurrency B through the end of 2022, even though the value of each unit of the cryptocurrency as of the end of the year was less than one cent. Taxpayer A retained the ability to sell, exchange, or otherwise dispose of Cryptocurrency B during 2022. Furthermore, Taxpayer A continued to exert dominion and control over Cryptocurrency B and, regardless of intent, did not take any affirmative steps to abandon the property during 2022. Therefore, Taxpayer A did not sustain a loss pursuant to section 165(a) in 2022 due to abandonment.[4]

If you have any questions, please contact Morgan Lawrence at (202) 317-7011.

Sincerely,

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[4] Because Taxpayer A did not take any action to abandon and permanently discard Cryptocurrency B, we need not discuss other requirements for a section 165 loss deduction, including the first two prongs set forth in Treas. Reg. section 1.165-2(a).