Failures in Cryptocurrency Exchanges Create Tax Challenges for Investors

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Rise & Fall of Cryptocurrencies in 2022

In 2022, several centralized cryptocurrency exchanges filed for bankruptcy due to being overleveraged, dragging the overall cryptocurrency market down. The total cryptocurrency market capitalization (or market cap) peaked in late 2021 at approximately $3 trillion, but as of this writing is now under $1 trillion.[1] Investors that held assets on centralized cryptocurrency exchanges likely want to know what their options are for recouping losses on their federal income tax returns.

Cryptocurrency is becoming a household term, even though it is perhaps the most volatile and controversial asset class today. It is estimated that at least 17% of American adults, or 46 million Americans, owned cryptocurrency in 2021.[2] Boston Consulting Group (BCG) is also bullish on cryptocurrency adoption. Likening the adoption curve of cryptocurrency to the adoption of the internet, BCG predicts there will be 1 billion cryptocurrency users by the year 2030.[3]

One example, bitcoin, the world's largest cryptocurrency by market cap, isn't a currency in the traditional sense. Bitcoin is a programmable technology that allows two parties to directly transact without a third-party intermediary. Currency is just the first application of this wildly speculated asset. Satoshi Nakamoto, the creator of bitcoin, described it as, "an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party."[4]

This article provides a background on the collapse of the cryptocurrency market in 2022, including what led to the bankruptcy filing of FTX.com. Then, we will address taxpayers' federal income tax considerations as a result of bankruptcy filings by a cryptocurrency exchange.

Background

What caused the cryptocurrency market cap to drastically fall in 2022? The simple answer is leverage. Most of the decline started in May 2022 with the collapse of Terraforms Labs' UST and LUNA tokens. UST was meant to be a U.S. dollar-pegged stablecoin. What actually resulted was chaos.

What Is a Stablecoin?

A stablecoin is a digital asset meant to maintain a peg to a more stable currency like the U.S. dollar or Euro. USDC and USDT are examples of fiat-backed stablecoins that hold reserves of U.S. dollars, treasuries, money market funds, and bonds that (ideally) match or exceed the total supply of their token. Algorithmic stablecoins are not backed by any fiat assets and instead rely on clever mechanisms to balance the value of the stablecoin.

Terra (LUNA)

Terra USD (UST), an algorithmic stablecoin, attracted investors by offering a 20% yield on staked UST. Staking is the process of locking up cryptocurrency tokens for a period of time to help secure the blockchain. UST was meant to maintain a $1 for $1 peg but lost that peg in May 2022, when over $2 billion worth of UST was unstaked and liquidated for LUNA. LUNA, a separate but related cryptocurrency token from UST, was used to stabilize the valu of the UST token. Owners of UST could swap one UST for $1 worth of LUNA at any time.

When $2 billion UST was liquidated in a 24-hour period on May 7, 2022, UST lost its peg to the dollar and was quickly trading at about 90 cents. This allowed UST owners to liquidate 90 cents worth of UST for $1 of LUNA. Now, with many UST owners panicking, more and more UST were being liquidated which led to more circulating supply of LUNA. Readers who are familiar with basic economics will know that higher supply of an asset generally results in lower prices. So, flooding the market with more LUNA created price pressure, driving down the value of the LUNA token from nearly $120 to less than one cent and effectively making UST worthless. The collapse of LUNA created losses for many investors, Three Arrows Capital (3AC) being one of those.[5]

3AC

3AC is an investment fund that invested in several cryptocurrency projects, including LUNA. 3AC invested over $200 million in LUNA, so the collapse of LUNA made this investment effectively worthless.[6] 3AC managed about $10 billion worth of assets before the LUNA collapse and coupled with the suppression of overall cryptocurrency market prices with rising interest rates, eventually led to 3AC's bankruptcy filing on July 1, 2022.[7] At the time of 3AC's bankruptcy filing, creditors included Celsius, Voyager, BlockFi, and Genesis Global.[8] It is reported that FTX was also involved with 3AC. When asked about the FTX bankruptcy, 3AC founder, Zhu Su, recently stated they (3AC) were "scammed just like you guys, it's ok—justice is coming."[9]

FTX

It is reported that Alameda Research, FTX's sister company and investment fund, also fell victim to the LUNA collapse.[10] This perpetuated Alameda Research to find itself in a hole, leading to reports that FTX may have loaned customer deposits to Alameda to resolve Alameda's insolvency. When a CoinDesk report hinted at FTX's insolvency on November 2, Binance, the largest crypto exchange in the world, announced they would be selling $584 million in FTX's token, FTT.[11] This incited a "bank run" on FTX where customers rushed to remove their assets from the exchange. FTX didn't have the liquidity to support all of its customer withdrawals, leading to a Chapter 11 bankruptcy filing on November 11.

Others

Celsius and Voyager, both creditors to 3AC, went on to file for bankruptcy as well. BlockFi was going through with a sale to FTX at the time FTX filed for bankruptcy, and has since filed for bankruptcy as well. BlockFi cited $355 million stuck on FTX on top of a $671 million loan to Alameda Research that Alameda defaulted on was a core reason for the bankruptcy filing.[12] Genesis Global is under a lot of pressure and has halted all activity as of November 16, 2022. It remains to be seen if Genesis Global will weather this storm.

Bankruptcy Procedures

Many taxpayers that fell victim to crypto-industry bankruptcy filings may likely be left waiting on a resolution for an extended period of time. For example, another high-profile bankruptcy proceeding, Enron, took almost seven years for shareholders and investors to reach a lawsuit settlement.[13] Similarly, Mt. Gox, a former cryptocurrency exchange that once accounted for 70% of all bitcoin trading, filed for bankruptcy in 2014 after having hundreds of thousands of bitcoin stolen.[14] The courts and Mt. Gox creditors did not reach an agreement on a rehabilitation plan until November 2021. To date, Mt. Gox still has not paid out all of its creditors.

Generally, secured creditors receive priority over unsecured creditors in bankruptcy proceedings. Secured creditors are granted priority on debt collection from the property on which they hold a lien. Unsecured creditors do not have this luxury. Generally, the best way for unsecured creditors to recoup their money is from voluntary repayment. If voluntary repayment is not an option, unsecured creditors must sue and win a judgment to get repaid or work with the court system on a settlement. It is best to consult with an attorney to determine if you are considered a secured or unsecured creditor and how you may be able to recoup your money if you are impacted by a cryptocurrency bankruptcy.

In the case of FTX, Messari research analyst Kunal Goel estimates that 40–50% of customer deposits may be recoverable.[15] But as we've seen in other high-profile cases, it may take years for customers to see any of this money. In a highly inflationary period, customers and investors waiting a long period of time to recoup their money may be stuck wishing they had just written off the entire loss.

Federal Tax Options & Considerations

Taxpayers who fell victim to one of the aforementioned cryptocurrency bankruptcy filings may likely want to recoup their economic loss in their tax filings. To do so, there are several different avenues that come to mind, so let's dive into them.

Casualty or Theft Loss

An argument can be made that FTX founder Sam Bankman-Fried's actions resulted in theft of taxpayers' deposits and went against FTX's terms and conditions by loaning customer deposits to Alameda. While this argument may have merit, the *Tax Cuts and Jobs Act of 2017* sunsets 2% itemized deductions through 2025. The 2% rule limits certain miscellaneous itemized deductions for items like investment and advisory fees. Since casualty and theft losses fall under the 2% itemized deduction category and theft losses are reportable in the year that they are discovered, reporting a theft loss in 2022 should not result in any tax

deductions for the 2022 tax year. Note, certain casualty and theft losses may still be deductible, but only if attributable to a federally declared disaster

Worthless Investment

Internal Revenue Code Section 165(g) allows taxpayers to write off worthless securities. However, IRS guidance in Notice 2014-21 provides that cryptocurrency should be treated as property. This creates an unfortunate disconnect where cryptocurrency is classified as property instead of securities for federal tax purposes. In addition, this option also assumes that the investment is worthless. As noted earlier, while bankruptcy proceedings may drag out for years, taxpayers can reasonably expect to receive a portion of their initial investment; as such, this eliminates the notion that a taxpayer's cryptocurrency investments are truly worthless. As a result, taxpayers facing cryptocurrency losses likely cannot take advantage of Section 165(g).

Non-Business Bad Debt Loss

In some cases, such as Celsius, taxpayers may have entered a debtor-creditor relationship. The terms and conditions of the investment determine if a debtor-creditor relationship exists. In the example of Celsius, the terms and conditions say that any digital asset transferred to the earn platform constitutes a loan from the user to Celsius.[16] If it is determined that the taxpayer had a debtor-creditor relationship, then a non-business bad debt deduction under IRC Section 166(d) may be an option for a taxpayer to reduce their tax liability. Generally, non-business bad debt losses are treated as short-term capital losses. Documentation and taking action to recoup the loan are key in taking this deduction, and the debt must also be considered wholly worthless. Partial deductibility of a non-business bad debt is not allowed.

Abandonment Loss

Abandonment losses are allowed for intangible property under IRC Section 165(a). However, the taxpayer must prove three items:

1. Ownership of the property prior to abandonment
2. An intent to abandon the property
3. Affirmative action to abandon the property

The taxpayer shoulders the burden of proof for all three items. In the case of the multiple cryptocurrency exchange insolvencies, it is wise to keep documentation of the purchases on each platform. This could help substantiate ownership of the property before the abandonment. The second and third criteria are typically determined based on facts and circumstances. In order meet the criteria for intent to abandon the property, "express

manifestation" is required. This may require documentation of conversations with legal counsel and written documentation with the entities that filed for bankruptcy themselves. As is common in cryptocurrency reporting, accurate records are key. Documentation for the amount claimed as a deduction for the abandonment of property is critical. As such, taxpayers should download a copy of their transaction history before these entities potentially remove access to user accounts.

Abandonment of intangible property is generally treated as an ordinary loss. The burden of proof and proper documentation are critical when taking this position to preserve the ordinary loss characterization. For example, in Watts v. Commissioner, the IRS reclassified an ordinary loss to a capital loss because the taxpayer failed to provide proper documentation.

Ponzi Scheme Exception

IRS Revenue Ruling 2009-9 provides tax relief to taxpayers that fall victim to Ponzi schemes. The example provided in the Revenue Ruling describes Taxpayer (A) opening an investment account with investment advisor B. Taxpayer A entered into a transaction for profit and A instructed B to reinvest any income and gain earned on investments. In a later year, it was discovered that B's activity was in fact a fraudulent investment arrangement known as a "Ponzi" scheme.

The Revenue Ruling describes a scenario allowing a reportable loss for the amount of A's original investment. The Revenue Ruling states, "A's loss also includes the amounts that A reported as gross income on A's federal income tax returns. If A has a claim for reimbursement with respect to which there is a reasonable prospect of recovery, A may not deduct in Year 8 the portion of the loss that is covered by the claim." The reportable loss is also reduced by any withdrawals provided to the client.

The question at hand then becomes: Was FTX a Ponzi scheme? Revenue Ruling 77-17, states that officers or directors merely committing fraud is not sufficient to deem their actions as a Ponzi scheme, but that their intent to defraud is a material factor.

This deduction is claimed on Form 4864 and Schedule A of Form 1040. A safe harbor under Revenue Procedure 2009-20 is an additional option. While this is considered a theft loss (previously discussed above), it is still allowed as a deduction in tax years 2018–2025.

Calculating the Economic Benefit

Working through the arithmetic in each scenario outlined above likely has a different outcome. For example, if Taxpayer A held $10,000 on FTX and has an effective tax rate of 21%, and Taxpayer A reports the $10,000 as an ordinary loss under the abandonment of intangibles rules, the taxpayer should realize a net tax benefit of $2,100 (10,000 x 21%).

However, had the taxpayer waited until the FTX bankruptcy proceedings were complete and hypothetically received $4,000 of their $10,000 investment, this cash position may be better than paying $2,100 less tax. In this example, the taxpayer may also be able to claim a $6,000 capital loss on top of the $4,000 they received because of the bankruptcy proceedings. Of course, the taxpayer will also need to weigh time value of money since these bankruptcy proceedings could drag on for years. However, if taxpayers can reasonably expect to receive a portion of their initial investment, they may have no other option than to wait.

Ultimately, the facts and circumstances for each taxpayer may be different. There is no blanket answer for all taxpayers that have been impacted by these cryptocurrency insolvencies. These unfortunate situations have created a complex tax situation for many taxpayers. As such, accountants and tax advisors should independently analyze the facts and circumstances of each taxpayer before determining how to report these losses.

Reach out to a professional at **FORVIS** if you have any questions.

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