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# **The Essentials of Crypto Tax Loss Harvesting**

**Mark Leeds**  
**Mayer Brown LLP**

# Abandonment

- Abandonment has 3 elements:
  - Loss occurred in a transaction entered into for profit
  - Sudden termination of usefulness
  - The property is permanently discarded
- Abandonment requires an overt act “express manifestation of abandonment.”
- Abandonment does not require proof of complete worthlessness
- Abandonment losses are ordinary in character.

# Worthlessness

- Worthlessness must be established by an identifiable event.
- Worthlessness security losses are treated as sales or exchanges, resulting in capital losses.
- Since cryptocurrencies are not considered securities, a worthlessness deduction would be ordinary.
- “Mere” diminution in value does not establish worthlessness.

# Theft Losses

- Theft losses generally are a subcategory of casualty losses.
- If the theft occurs in a transaction entered into for profit, the theft loss is not subject to general limitations applicable to theft losses and not treated as miscellaneous itemized deductions.
- Theft losses are ordinary unless the theft relates a sale or exchange transaction, in which case, the loss is capital.
- Revenue Ruling 2009-9 guidance on the Madoff ponzi scheme could be helpful in cases like FTX.

# CCA 202302011 Background

- Most likely direct guidance on TerraUSD (“UST”). UST was a stablecoin not backed by hard assets. Makes clear that UST is not a security.
- It linked to LUNA, its blockchain native currency. If UST was exchanged for LUNA, the UST was destroyed (burned).
- Since UST would always buy \$1 of LUNA, if UST started trading for \$.99, holders would exchange for LUNA, making an instant profit.
- LUNA unraveled and by May 2022, UST was trading for \$.02.

# CCA 202302011 -- No Abandonment Deduction

- Taxpayer maintained ownership
- Retained the ability to sell or otherwise transfer crypto
- No affirmative steps to abandon
  - Where would the taxpayer send notice of her intent to abandon?
- Claim of abandonment likely precludes capital loss
- Abandonment loss would not result in a tax loss for taxpayers who treat the loss as a miscellaneous itemized deduction

# CCA 202302011 -- No Worthlessness Deduction

- Even a modest fraction of value precludes a worthlessness deduction. But see Rev. Rul. 71-577 – trivial recovery value ignored.
- But CCA recites that value of a fraction of a penny precludes worthlessness.
- Worthlessness loss would not result in a tax loss for taxpayers who treat the loss as a miscellaneous itemized deduction

# Loss Harvesting Platforms

- Certain platforms will allow crypto holders to sell worthless cryptocurrency positions for 1 cent.
- Transfers are structured to constitute *bona fide* sales.
- Given the IRS position on worthlessness as expressed in CCA 202302011, the sales should not be disregarded on the ground that the cryptocurrency is worthless.



# Celsius Bankruptcy

- NY bankruptcy court has ruled that participants in Celsius Earn program were unsecured creditors.
- The investors & traders who deposited cryptocurrency on the Celsius platforms traded their coins in exchange for a promise on the part of Celsius to return the coins later.
- Accordingly, Celsius was not a custodian or broker holding the cryptocurrency; it was acting as a counterparty
- Decision is heavily dependent upon the Earn platform user agreement.

# Celsius Bankruptcy – Tax Issues

- Does the bankruptcy ruling allow depositors to claim a current loss?
  - As we'll see, IRS authority supports a loss.
- When is the loss determined?
  - Loss should be determined at the time the Exchange fails to honor its obligation to return the cryptocurrency to the lender
- What is the character of the loss?
  - Loss should be capital in character.

# Crypto Lending Is Analogous to Securities Lending

- Securities Lending Agreements have 4 characteristics:
  - Must be in writing;
  - Provide for a return of items that are identical to those lent;
  - Borrower must make substitute interest or dividend payments;
  - Must not reduce lender's opportunity for gain (require return within 5 days from demand) or risk of loss
- Code § 1058 provides no gain or loss is recognized upon the transfer of **securities** under a securities lending agreement.
- Code § 1058 does not apply to loans of securities

# IRS GCM 36948

- In GCM 36948, the IRS addressed securities lending tax issues prior to the enactment of Code § 1058
- The reasoning of the GCM should apply to cryptocurrency lending transactions.
- GCM holds that the transfer of property in exchange for a promise to redeliver identical property in the future is a disposition
- Code § 1001(a) would treat disposition as taxable if what is received back differs materially in kind or extent.

# IRS GCM 36948 con't

- Open transaction doctrine applies to defer the determination of whether what is received differs materially in kind or extent.
- Tax consequences are held in abeyance until the borrower satisfies its obligation to the lender.
- If borrower returns identical property, then even though there has been a disposition, since the return property did not differ in kind or extent, the disposition is non-taxable.
- When borrower defaults, the open transaction doctrine should cease to apply at that time.

# Wash Sales

- A wash sale occurs when:
  - a taxpayer sells stocks or securities
  - & within the 61-day period beginning before the sale, she buys substantially identical stocks or securities or
  - Enters into a contract or option to acquire substantially similar stocks or securities.
- If a wash sale occurs, any loss sustained on the sale leg will be disallowed & added to the basis of the replacement leg.
- Wash sales should not apply to cryptocurrency sales, provided that the cryptocurrency is treated as a commodity. IRS Notice 2014-21.

# THANK YOU

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