Cryptocurrency Loans—Taxable or Not?

By Joshua Tompkins and Hubert Raglan

Joshua Tompkins and Hubert Raglan examine the proper tax treatment of cryptocurrency loans, a financial product that has recently emerged in the budding cryptocurrency industry.

Introduction

In January 2009, during the depths of the great recession, the genesis block of the Bitcoin blockchain and the first bitcoin was mined by the elusive Satoshi Nakamoto. While originally envisioned as a form of "electronic cash" for peer-to-peer ecommerce transactions to bypass the payment infrastructure maintained by financial institutions, its invention spawned a new asset class broadly called "cryptocurrency" along with a rapidly growing ecosystem of Fintech businesses, participants, products and transactions that mirror traditional financial services.[1] Although Bitcoin and other cryptocurrencies were once thought to be a passing fad among tech-savvy enthusiasts, penetration and adoption by the mainstream is now undeniable and cryptocurrency is traded on more than 150 exchanges worldwide. Similar to other investment products such as stock, securities, foreign currency, and certain commodities such as gold and silver, certain market participants desire a "short" position in a cryptocurrency.[2] As part of the ongoing development of the cryptocurrency markets, platforms have emerged that allow owners of cryptocurrency to earn a return by "lending" their cryptocurrency to parties that need to borrow cryptocurrency to effectuate a short sale.

In a typical[3] cryptocurrency short sale, the short seller (the "cryptocurrency borrower") borrows cryptocurrency from a third party (the "cryptocurrency lender"), and becomes obligated to pay an interest-like return over the term of the cryptocurrency loan and return identical cryptocurrency in the future. Naturally, the cryptocurrency borrower is entitled to sell or otherwise dispose of the borrowed cryptocurrency to effectuate their short sale or cover a previous short sale. The cryptocurrency borrower must transfer to the cryptocurrency lender any additional cryptocurrency received as a consequence of holding the loaned

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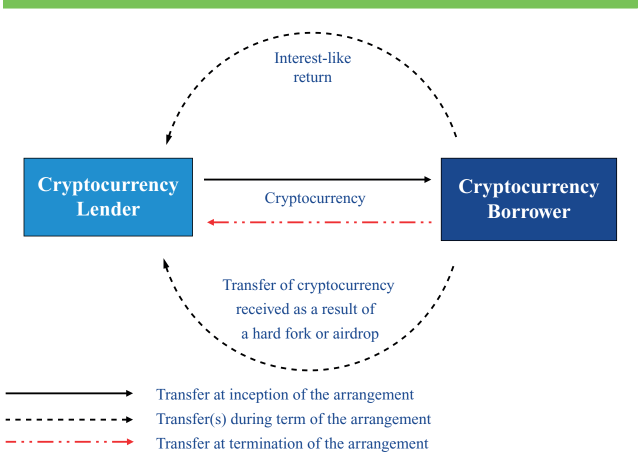
cryptocurrency (*e.g.*, cryptocurrency received as a result of a "hard fork" or "airdrop"). These payments must be made in kind (*i.e.*, by transferring the additional cryptocurrency units rather than an amount of money equivalent to the fair market value of the cryptocurrency received in a hard fork or airdrop). Typically, a cryptocurrency loan may be terminated on demand by either party with settlement of the cryptocurrency loan within several days following notice. Further, typical cryptocurrency loans do not have a cash settlement feature (*see* Graphic 1).

The taxation of cryptocurrency loans raises several questions. The most significant area of uncertainty, and the focus of this article, is whether a cryptocurrency loan results in the realization and recognition of gain or loss by the cryptocurrency lender. At the outset, we will admit that there is no clear answer to this question. Cryptocurrency is not subject to a detailed statutory or regulatory regime and IRS guidance to date has not focused on cryptocurrency loans. However, this is not altogether atypical in the realm of financial products, as taxpayers' ability to devise new financial arrangements will always outpace the government's ability to write comprehensive rules to govern their taxation. In the absence of guidance, the tax characterization of many financial transactions is determined on a case-by-case basis through analogy to existing transactions with an established tax treatment.[4] We propose to continue that tradition. To that end, this article will begin by providing an overview of the basic rules that control when gain or loss is realized and will then evaluate these considerations in more detail in the context of several potentially analogous transactions. We hope, rather than expect, that this process will throw some much needed light on how cryptocurrency loans should be treated for tax purposes.

GRAPHIC 1. DIAGRAM OF A CRYPTOCURRENCY LOAN



Sales, Exchanges, and Tax Ownership

With limited exceptions, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.[5] Said slightly differently, the realization of gain or loss has two requirements: (1) there must be a sale or exchange (the "exchange requirement") and (2) the property received in the sale or exchange must differ materially either in kind or in extent from the property sold or exchanged (the "material difference requirement").

In order to determine whether the exchange requirement has been met, the tax authorities generally look to whether ownership has transferred from one party to the other.[6] If ownership is transferred, the transaction is generally treated as a sale or exchange. If sufficient benefits and burdens of ownership are not transferred, the authorities may look to recharacterize the transaction as something other than a sale or exchange (*e.g.*, a financing, lease, or agency relationship). Although title and non-tax legal ownership are relevant considerations in this analysis, they are not controlling. A particularly influential authority in the arena of tax ownership is the Tax Court's opinion in *Grodt & McKay Realty*.[7] In the decision, the Tax Court enumerated the following eight factors that are frequently relied upon when making the determination of whether the benefits and burdens of ownership have passed from a seller to a purchaser: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract created a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession vested in the purchaser; (6) which party pays property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.[8]

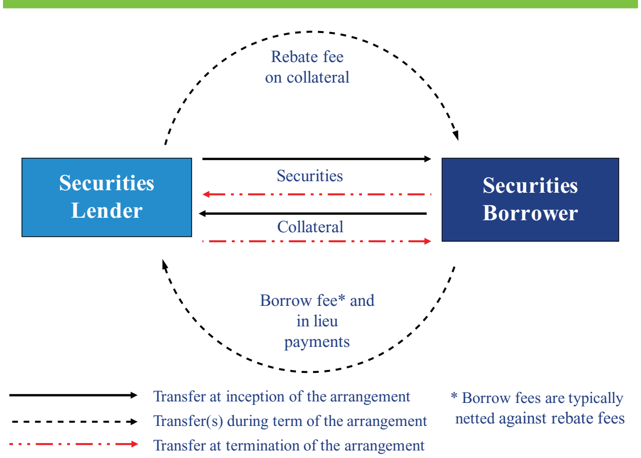
Grodt & McKay involved a purported sale of livestock and, similarly, a number of authorities with respect to tax ownership have developed in connection with purported sales or purported non-sales of tangible property. As succeeding decisions have made clear, the factors that are relevant, and the weight to be accorded to each factor, must be determined in light of the nature of the property involved.[9] Thus, while the tangible property ownership factors enumerated in *Grodt & McKay* provide useful guidelines and are generally used as a starting point when evaluating tax ownership, they must be evaluated in context when applying the factors to other arrangements and assets. Of particular importance are common commercial practices and the attributes of the assets in question. As will be demonstrated below, in the context of liquid and fungible property, courts have generally placed significant emphasis on which party is able to dispose of the property.

Securities Lending Transactions

In a securities lending transaction, the owner of securities (the "securities lender") lends securities to a borrower (the "securities borrower"). The securities borrower, pursuant to a written contractual agreement, is obligated to return a like quantity of the same type of security as was lent by the securities lender. In the typical securities lending transaction, either party may terminate the securities loan at any time. Also, a typical securities lending transaction requires the securities borrower to post collateral with the security lender to ensure payment. The securities borrower must pay a "borrow fee" to the securities lender over the term of the securities loan.[10] This fee is typically netted against the "rebate fee" the securities lender must pay the securities borrower on any cash collateral. Finally, the securities borrower must make payments to the securities lender equal to any interest or dividends on the borrowed security ("in lieu payments") (*see* Graphic 2).

The ability of either party to terminate the securities loan, coupled with the securities borrower's obligation to make in lieu payments ensures the economic benefits and burdens of ownership remain vested with the securities lender. Nevertheless, early in the history of the tax law, the Supreme Court decided in *Provost*[11] that a securities lender should not be treated as the tax owner of the loaned securities. The Court dismissed the government's argument that a securities lender should be treated the same as

GRAPHIC 2. DIAGRAM OF A SECURITIES LOAN



an investor that pledges its securities with a broker, which previous decisions had held does not give rise to a sale.[12] While a broker can sell the pledged securities, the broker must continue to maintain "on hand specific securities for delivery to the customer on payment of the amount of the broker's advances for the customer account."[13] However, in a securities lending transaction, the borrower is not required to retain enough securities on hand to satisfy the securities loan, and, in fact, the opinion states that in a securities lending transaction, the borrower is not expected to maintain securities on hand.[14] The court determined that, "[f]or the incidents of ownership, the [securities] lender has substituted the personal obligation, wholly contractual, of the [securities] borrower to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into."[15] Many commentators agree that *Provost* necessarily implies that control is one of the most important factors, and perhaps even the overriding factor, when determining the tax ownership of liquid securities.[16] The emphasis on control is a consequence of the fundamental principle that there may be only one owner of property.[17] With fungible properties, a potentially unlimited number of parties could attain economic exposure through derivative contracts and other financial transactions. As a result, the ability to dispose of the property, rather than economic exposure to the referenced property, must control the tax ownership determination if there is to be a single tax owner.

Despite resulting in a transfer of tax ownership, securities lending transactions have generally not been treated as giving rise to taxable gain or loss. For example, in Rev. Rul. 57-451,[18] the government determined that a stock loan did not result in recognizable gain or loss. The ruling acknowledged the *Provost* decision and its implication that a securities lending transaction involved a sale or exchange. However, instead of viewing the transaction as an exchange of stock for a contractual obligation to return identical stock in the future (as the discussion in *Provost* might appear to imply),[19] the government reasoned that "[a] simultaneous delivery of property is not essential to an exchange" and "[i]f the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other side." In other words, the receipt of the security borrower's contractual obligation to return identical securities was simply an intermittent step in a single exchange transaction. On the basis that the stock loaned was transferred in a non-simultaneous exchange for stock in the same corporation, the government determined that the exchange was non-taxable under Code Sec. 1036, which provides that "[n]o gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation."[20]

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Securities lending transactions generally require the securities borrower to return stock identical to the stock originally loaned. It is therefore not clear that Code Sec. 1036 was required to achieve non-recognition, as the stocks exchanged would not meet the materially different requirement needed to result in the realization of gain or loss. In GCM 36948,[21] the government reconsidered its reasoning in Rev. Rul. 57-451 and came to this very conclusion, stating that "[i]n the typical case where the broker-dealer satisfies his contractual obligation by delivering securities not differing materially in either kind or extent, there will be no realization of gain or loss under Code §1001 because of Treas. Reg. §1.1001-1(a) … Accordingly, the exchange will be non-taxable since there is no gain which could be taxed in any event, thus obviating the need to apply a specific statutory provision such as Code §1036 so as to afford non-recognition treatment for gain or loss realized." Taken together, the early guidance provided in Rev. Rul. 57-451 and GCM 36948 (the "pre-Code Sec. 1058 guidance") sets forth two distinct conclusions. First, the transfer of securities pursuant to a securities lending transaction is an exchange. Second, this exchange does not result in the realization of gain or loss because the securities are exchanged for identical securities and the materially different requirement is not met.

This treatment was codified, albeit in a slightly different formulation, when Congress enacted Code Sec. 1058 in 1978. If the requirements under Code Sec. 1058 are satisfied, the lender is generally not required to recognize gain or loss in connection with entering into the securities loan. Congress indicated these requirements were intended "to assure that the *contractual obligation* does not differ materially either in kind or extent from the securities exchanged…"[22] Therefore, Code Sec. 1058 differs from pre-Code Sec. 1058 guidance by treating a securities lending transaction as an exchange of a security for a contractual obligation to deliver an identical security.[23]

Under both Code Sec. 1058 and the pre-Code Sec. 1058 guidance, a securities lending transaction is considered an exchange. Thus, the focus is on whether the property received in the exchange meets the materially different requirement. The legislative history indicates that the satisfaction of the conditions delineated in Code Sec. 1058(b) is sufficient to ensure that the contractual obligation received by a securities lender at the inception of a securities loan does not differ materially in kind or in extent from actual ownership of the securities loaned.[24] To meet these requirements a securities lending transaction must (1) provide for the return to the transferor of securities identical to the securities transferred (the "identical securities requirement"); (2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor (the "in lieu payment requirement"); and (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred (the "risk and opportunity requirement").

The risk and opportunity requirement has been the subject of some debate. In 1983, the government issued proposed regulations indicating this requirement will only be satisfied if the lender may terminate the loan upon notice of not more than five business days (the "five-day rule").[25] This rule was presumably based on the then-market standard of a five-day notice and return period. The proposed five-day rule has been the subject of significant criticism because it implements an extra-statutory requirement that is not aligned with transactions that are considered ordinary course securities loans under current market norms.[26] The Tax Court initially endorsed this five-day rule,[27] but subsequent decisions have suggested that "the question of whether securities loans for shorter fixed terms, made for the purposes animating §1058, qualify for non-recognition treatment is more appropriately settled by further guidance from the Department of the Treasury and the IRS."[28] The proposed regulations have also been criticized because they provide that the exchange of a security for a contractual obligation that does not meet the Code Sec. 1058(b) requirements (as expanded to include the five-day rule) would result in the recognition of gain or loss.[29] In other words, the proposed regulations take the position that Code Sec. 1058(b) is not a safe harbor, but rather the arbiter of whether gain or loss is realized. There are reasons to doubt Congress intended Code Sec. 1058 to operate in this manner. For one, Code Sec. 1058(a) uses the term "non-recognition" rather than "non-realization." Gain or loss is generally not recognized without having first been realized, which implies that the provision is not intended to determine whether a realization event has occurred. Instead, a fair interpretation would be that Code Sec. 1058 was formulated as a non-recognition overlay to the general realization principles espoused in the pre-Code Sec. 1058 guidance. Many commentators take this view.[30]

The typical cryptocurrency loan appears to meet each of the requirements enumerated in Code Sec. 1058(b). Cryptocurrency loans require the cryptocurrency borrower to return identical cryptocurrency to the cryptocurrency borrowed and therefore meet the identical securities requirement. Cryptocurrency loans typically require payments to be made in kind in the event a "hard fork" or "airdrop" results in the receipt of additional cryptocurrency, which should be sufficient to meet the in lieu payment requirement. Further, while the terms of cryptocurrency loans can and do vary, they generally contain provisions intended to ensure the risk of loss or opportunity for gain is not transferred to the cryptocurrency borrower, such that the risk and opportunity requirement is met. This would include the ability to terminate the cryptocurrency loan within a five-day notice period. Thus, it can be said that the contractual obligation received in a securities loan does not differ materially in kind or extent from the actual ownership of cryptocurrency.[31]

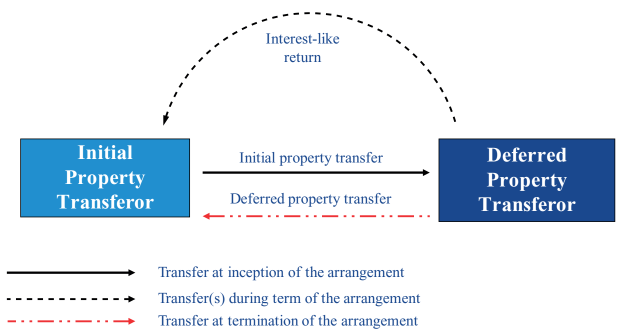
Yet, the scope of Code Sec. 1058 is not all encompassing. By its terms, the statute only applies if the property transferred at the inception of a securities loan and received at the end of the securities loan is a "security" as the term is defined in Code Sec. 1236(c).[32] Code Sec. 1236(c) defines a security as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." It is not altogether clear why the cross-reference to Code Sec. 1236(c) was included. The legislative history to Code Sec. 1058 suggests that Congress was chiefly concerned that uncertainty as to the non-taxability of securities loans was restricting market liquidity and that the statutory provision was simply aimed at sectors of the economy for which liquidity was most important. The motivations for parties to engage in cryptocurrency loans closely mirror those for securities loans, and liquidity would seem equally desirable in the cryptocurrency markets. Moreover, given Congress's description of Code Sec. 1058 as a "clarification" of prior law, it is entirely possible that Code Sec. 1058 is simply an expression of broader tax principles and that an agreement meeting the requirements of Code Sec. 1058(b) would not differ materially in kind or extent from actual ownership of the referenced property.[33] Thus, while it seems highly unlikely that cryptocurrency would fall within the statutory purview of Code Sec. 1058 as a security, there is a strong policy-based argument that similar principles ought to apply to cryptocurrency loans as adoption and use of cryptocurrency continues to grow rapidly. If a cryptocurrency loan were analogized to a securities loan under Code Sec. 1058, gain or loss would not be realized unless the contractual obligation received differs materially in kind or extent from the cryptocurrency exchanged. In cases where the contractual obligation meets the requirements described in Code Sec. 1058(b), it appears that the materially different requirement would not be met. Accordingly, gain or loss would not be realized upon entering into a cryptocurrency loan or upon closing a cryptocurrency loan through the delivery of cryptocurrency back to the cryptocurrency lender.

The analogy to a securities lending transaction is strengthened if one believes, as many do, that Code Sec. 1058 functions largely as a safe harbor and that the principles of the government's previous guidance survived the enactment of Code Sec. 1058.[34] While those authorities dealt with securities, one could reasonably argue that the same principles should apply to economically similar financial products (*e.g.*, cryptocurrency). We understand that market participants currently take this position with respect to non-Code Sec. 1236(c) securities that are economically similar to stock or debt (*e.g.*, interests in publicly traded partnerships and real estate investment trusts).[35] If the pre-Code Sec. 1058 guidance is applied to a cryptocurrency loan, it is clear that the materially different requirement is not met because the properties exchanged are identical (*i.e.*, cryptocurrency is exchanged for identical cryptocurrency). Given the similarity of a securities loan to a cryptocurrency loan, both in terms of economics and purpose, it seems that this type of analogy would be grounded on sound policy and particularly persuasive as a technical matter.

Deferred Exchange Transactions

As demonstrated above, the pre-Code Sec. 1058 guidance relied to some extent on the concept of a "non-simultaneous" or "deferred" exchange. The concept of

GRAPHIC 3. DIAGRAM OF A DEFERRED EXCHANGE



a deferred exchange has also been applied outside the context of securities loans, which demonstrates that the underlying reasoning is not confined to a particular asset class. In some cases, the executory contract under which property was exchanged also provided for an interest-like return to the party that delivers property first, similar to the interest-like return in a cryptocurrency loan or the borrow fee in a securities loan (*see* Graphic 3).

The deferred exchange transaction is best illustrated by *Starker*.[36] In *Starker*, the taxpayers entered into a "land exchange agreement" with a third party under which the Starkers agreed to convey timberland properties to the counterparty in exchange for the counterparty's agreement to transfer similar properties with an equivalent value to the Starkers within five years. As part of the contract, the counterparty agreed to add to the Starkers' credit each year a "growth factor", equal to six percent of the outstanding balance. If the counterparty was unable to acquire suitable property, the value of the properties transferred plus any accrued growth factor would be paid in cash. The Starkers reported no gain on the transaction, taking the position that the transaction was entitled to non-recognition treatment under Code Sec. 1031. The government contended that Code Sec. 1031 was inapplicable for two reasons. First, the government argued that the possibility of cash settlement meant that the right to receive property or cash in the future was "like cash" rather than property of like-kind to the property transferred by the Starkers. Second, the government contended that the term "exchange" contemplates a simultaneous transfer of property and that the deferred exchange undertaken by the Starkers did not qualify for non-recognition treatment as a result. The court held that the mere possibility at the time of agreement that a cash sale might occur did not create a "cash equivalency" and that a line of authorities supported treating deferred exchanges as exchanges, even if the initial transfer and the consummation of the exchange were separated by a substantial period of time.[37] Courts have, however, held that an unrestricted use of a cash deposit can defeat deferred exchange characterization.[38]

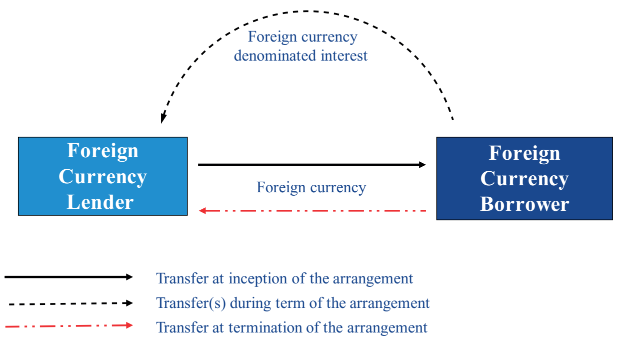
Arguably, the principles undergirding *Starker* should apply whenever one party to the contract delivers property to the counterparty, and in return receives identical property at a future date. While changes made to Code Sec. 1031 by the Tax Cuts and Jobs Act mean that this provision is no longer directly applicable in the context of a cryptocurrency loan,[39] a non-recognition provision is not needed to prevent the recognition of gain or loss if the properties exchanged are identical.[40] Therefore, if a cryptocurrency loan were analogized to a deferred exchange, the transaction would be given open transaction treatment until the contract settled. The delivery of cryptocurrency from the cryptocurrency borrower back to the cryptocurrency lender would be an exchange of property (the cryptocurrency lent) for property not differing materially in kind or extent (the cryptocurrency repaid) and no gain or loss would be realized. *Starker* is also significant because it confirms that the payment of an interest-like charge (such as the "growth factor") does not impede the characterization of a transaction as a deferred exchange.

There remains a question as to how long a deferred exchange can remain open. In *Starker* the deferral period was five years and there did not appear to be an ability on the part of the Starkers to terminate the arrangement on demand. This has led some to speculate that *Starker* might provide support for fixed-term securities loans. Similar principles might also apply in the context of cryptocurrency loans. While *Starker* contemplates a five-year deferral, it is important to note that Code Sec. 1031 was amended to require that the deferral period extend no more than 180 days after the initial exchange.[41] While this requirement is specific to Code Sec. 1031 and arguably does not impact the more general application of the principles underlying *Starker*, taxpayers seeking greater certainty might consider limiting their cryptocurrency loans to no more than a 180-day period. Staying within the 180-day period would also align with market practice in the securities lending space, which might further support non-realization.[42]

Foreign Currency Denominated Debt

In its purest form, debt is an unqualified promise to pay a sum certain on a specified date with fixed interest. While the income tax law contemplates instruments being treated as indebtedness if some payments of principal or interest

GRAPHIC 4. DIAGRAM OF A FOREIGN CURRENCY LOAN



are determined by reference to the value of property,[43] instruments that do not provide for principal protection typically are not characterized as indebtedness.[44] In fact, the IRS has described "[t]he presence of a sum certain payable at maturity" as a "sine qua non of debt treatment under the Code."[45] Foreign currency loans are something of an exception to this general rule. A U.S. dollar functional currency taxpayer might not recoup the amount loaned (in U.S. dollar terms) when lending in non-functional currency. Nevertheless, a foreign currency loan is typically respected as indebtedness. Presumably, this is because principal protection for foreign currency loans is measured in non-functional currency terms (*see* Graphic 4).

Foreign currency denominated loans are governed by a detailed statutory and regulatory regime under Code Sec. 988. If the foreign currency lender purchases a note from the borrower using foreign currency, the foreign currency lender realizes gain or loss on the disposition of the foreign currency lent. The gain or loss realized is equal to the difference between the fair market value of the currency and the foreign currency lender's adjusted basis in the currency.[46] Upon repayment of the loan, the foreign currency lender will again realize foreign currency gain or loss for the difference between the U.S. dollar value of the principal repaid and their U.S. dollar basis in the currency lent computed using the spot rate on the date the loan was made.[47]

Similar to cryptocurrency, non-functional currency is considered a type of property. Moreover, like foreign currency, cryptocurrency can function as a medium of exchange. This has led some to believe that the rules for foreign currency denominated loans might inform the proper tax treatment of a cryptocurrency loan. If that were the case, gain or loss would be realized on the transfer of the cryptocurrency to the cryptocurrency borrower equal to the difference between the fair market value of the cryptocurrency and the cryptocurrency lender's adjusted basis in the cryptocurrency transferred. The cryptocurrency lender would then take basis in the contractual obligation received equal to its basis in the cryptocurrency transferred, increased or decreased (respectively) for any gain or loss recognized. When the cryptocurrency was transferred back to the cryptocurrency lender, gain or loss equal to the difference between the fair market value of the cryptocurrency received and the cryptocurrency lender's adjusted basis in the contractual obligation would be recognized.

While foreign currency loans are superficially similar to cryptocurrency loans, there are several reasons why it does not appear appropriate to apply Code Sec. 988 principles in the cryptocurrency loan context. First, we would be remiss if we did not highlight the IRS position that cryptocurrencies are not foreign currencies for income tax purposes.[48] This may imply the government believes cryptocurrencies are sufficiently different from foreign currencies to warrant a different income tax treatment. Even if this distinction were simply made to align the tax characterization of cryptocurrency with its non-currency regulatory characterization,[49] it would seem difficult for the government to assert that cryptocurrency loans are taxable transactions by invoking Code Sec. 988 principles while simultaneously taking the position that cryptocurrency is not foreign currency for other purposes. While not entirely clear, it is also possible that the debt characterization of foreign currency loans is, to some extent, a consequence of the innate desire for transactional parity that permeates the income tax law. In most cases, foreign currency loans are only denominated in non-functional currency for the borrower or the lender, but not both. It would seem somewhat odd for one of the parties to treat the instrument as a loan (because the instrument would have principal protection when measured in the taxpayer's functional currency) whereas the other party would treat the instrument as something other than a loan (because the instrument would lack principal protection in U.S. dollar terms). As a matter of tax policy, one could argue that a taxpayer's functional currency should not control the income tax characterization of a transaction.[50] Cryptocurrency loans are significantly different from foreign currency loans in this respect, because a cryptocurrency loan will always represent a property transaction to both parties.[51] There are also typically economic differences between foreign currency loans and cryptocurrency loans which stem from the fact that they have different underlying purposes— *i.e.*, cryptocurrency loans are generally used to lend investment assets whereas foreign currency loans are generally used to lend money (from one party's perspective at least). The most significant economic difference is that, unlike the typical cryptocurrency loan described above, foreign currency loans are generally not subject to termination on the lender's demand. This difference might be sufficient to transfer risk of loss and opportunity for gain from the foreign currency lender to the foreign currency borrower and result in the obligation received differing materially in kind or extent from the foreign currency lent. This economic difference is evidenced, for example, by market participants' frequent hedging of foreign currency exposure associated with foreign currency denominated loans.

A close inspection of the history of foreign currency loan taxation is also informative. Prior to the enactment of Code Sec. 988, courts had held on several occasions that no gain or loss was realized upon the repayment of a foreign currency loan with depreciated or appreciated foreign currency.[52] Other decisions held that the repayment of a foreign currency loan is a taxable transaction.[53] While the non-taxability authorities were followed as recently as 1960,[54] the decisions that held foreign currency loans were taxable transactions generally antedate those that held no gain or loss was realized, and later courts considered these authorities controlling.[55]

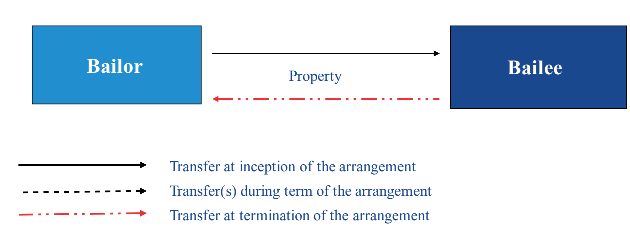
Beyond illustrating the generally confused state of the tax law and the difficulty courts experienced when grappling with these issues, these early cases are also interesting because they frequently applied, or at least considered, a short sale analogy when determining the tax consequences of a foreign currency borrowing.[56] This construct was also advocated by contemporary commentators.[57] If a foreign currency borrower is properly analogized to a short seller, the corollary is that the foreign currency lender, who stands opposite the foreign currency borrower, ought to be analogized to the securities lender. The sole case that considered the tax treatment of a foreign currency lender prior to the current statutory framework—*KVP Sutherland Paper Co.*[58]—did not consider this possibility. In that case, a domestic corporation engaged in the production and sale of paper made loans to its Canadian subsidiary in return for notes payable in Canadian dollars. The loans were repaid at a time when the Canadian dollar had increased in value in relation to the U.S. dollar over what it had been worth at the time the loans were made. The taxpayer immediately converted the Canadian dollars it received into U.S. dollars. Separating the transaction into more than one taxable event, the court held that the taxpayer realized gain upon the repayment of the loan by the Canadian subsidiary and also realized gain upon the conversion of the Canadian currency into U.S. dollars. The court's decision and its lack of consideration of the securities lending authorities is hardly surprising, because the facts of the case make it relatively clear that the hallmark features of a securities loans, and in particular the features intended to prevent the transfer of the risk of loss and opportunity for gain (*e.g.*, the lender's ability to terminate the transaction), were not present. Consequently, *KVP Sutherland Paper Co.* might not necessarily represent a refutation of the securities lending analogy in cases where a property loan is structured in a manner similar to a securities lending transaction.

Bailment for Profit

A bailment is a transaction which involves the temporary placement of control over, or possession of, personal property by one person, the bailor, into the hands of another, the bailee, for a designated purpose upon which the parties have agreed. At times, a loan of fungible and liquid property has been considered a bailment transaction. Generally, bailment transactions are not accompanied by a transfer of tax ownership. Therefore, if properly analogized to a cryptocurrency loan, the bailment authorities would indicate that the exchange requirement is not met (*see* Graphic 5).

Illustrative of the principles underlying the bailment authorities is *Stahl*,[59] in which the taxpayer "loaned" securities to a brokerage firm under an agreement allowing the firm to use the securities as part of its capital, in compliance with certain requirements of the Securities and Exchange Commission. The loan agreement provided that the securities were to be returned to Mrs. Stahl, but that her right to demand or receive payment or return of the securities was subordinated to the claims of all present and future creditors of the firm. As compensation for the loan, the brokerage firm agreed to pay Mrs. Stahl one percent of the market value of the securities every three months. Faced with financial difficulties, the brokerage firm sold the securities and subsequently filed for bankruptcy. Mrs. Stahl claimed an ordinary loss

GRAPHIC 5. DIAGRAM OF A BAILMENT



deduction in the amount by which her basis in the securities loaned to the firm exceeded her expected recovery from the bankruptcy proceeding. The Service disallowed the deduction on the grounds that the loss was in the nature of a non-business bad debt and that the debt had not become wholly worthless in 1963. This contention was rejected by the Court of Appeals for the District of Columbia, which held that the loss of securities was deductible under Code Sec. 165(c)(2) as a loss incurred in a transaction entered into for profit.

Much of the dispute in *Stahl* focused on the question of whether the loan of securities constituted a bailment or a bona fide debt. Relying on the fact that the written agreement described the transfer of securities as a loan and the resulting obligation as an indebtedness, and on the argument that "[w]hen securities are delivered in order to provide capital for another, it is reasonable to assume their 'return' can be satisfied by return of equivalent securities or cash," the government characterized the transaction as a debt. Its characterization was rejected by the court of appeals on the grounds that the loan agreement did not give the brokerage firm an unconditional power to sell the securities, as the government's cash return argument presumed, and that the obligation of the firm to return the securities was conditional, in that it was subordinated to the claims of the firm's creditors and subject to the risks of the firm's business. The court placed particular weight on the fact that the agreement did not provide for the return of money, but only securities stating, "[a] debt necessarily involves an obligation to pay money and not an obligation to deliver property."[60]

Subsequent informal guidance has indicated that bailment transactions will not be transformed into tax sales simply because fungible property is comingled with the goods of the bailee. For example, the government ruled in informal guidance that bullion could be comingled with other bullion so that its identity is lost (and different bullion would presumably be returned to the bailor) without triggering a tax sale.[61]

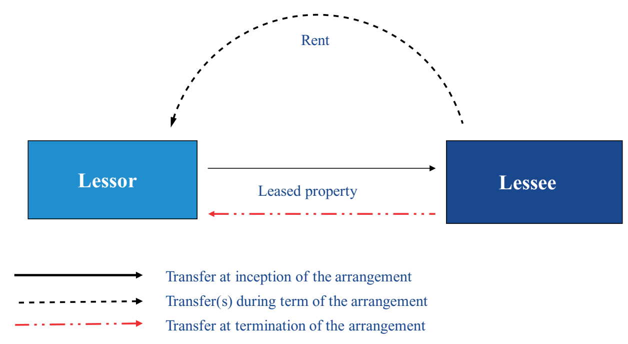
At first blush, these authorities seem to indicate that tax ownership is not transferred simply because the bailment property can be sold. However, it is important not to take this line or reasoning too far. For one, the guidance that considers whether comingling results in a tax sale does not contemplate a situation where the bailee is disposing of the bailment property to a third party without retaining any property on hand to satisfy its obligation to bailor. The fact that the bailee will be expected to have sufficient identical property on hand may be sufficient to prevent a transfer of tax ownership. This inference is supported by Provost, which stated: "Unlike the pledgee of stock who must have specific stock available for the pledgor on payment of his loan, the borrower of stock has no interest in the stock nor the right to demand it from any other. For that reason he can be neither a pledgee, trustee nor *bailee* for the lender, and he is not one 'with whom stock has been deposited as collateral security for money loaned.'"[62] Finally, it is important to note that the government never fully accepted the court's reasoning in *Stahl*, describing the case as "a mixed bag of acceptable and unacceptable reasoning."[63] The government specifically took issue with the court's conclusion that bona fide indebtedness was not created when the bailment property was sold. Again, this seems to support the conclusion that a sale of bailment property by the bailee to a third party triggers a transfer of tax ownership unless the bailee holds identical property on hand to satisfy their obligation to the bailor. Obviously, this will not typically be the case with a cryptocurrency loan, because the cryptocurrency borrower generally uses the borrowed cryptocurrency to effectuate a short sale. However, the bailment characterization may reach the correct tax results if the cryptocurrency loan's terms are substantially similar to the subordination agreements in *Stahl* and *Miami National Bank*. Factors relevant to the analysis would include whether the cryptocurrency lender has the right to substitute different units of the cryptocurrency loaned, the conditions or occurrence of events imbuing the cryptocurrency borrower with a right to dispose of the cryptocurrency, and possibly evidence that the units of cryptocurrency returned by the cryptocurrency borrower are in fact the same units of cryptocurrency initially transferred.[64]

Lease

Some practitioners have suggested that a cryptocurrency loan might be characterized for tax purposes as a lease, with the payments to the cryptocurrency lender being characterized as "rent." In the typical lease, the lessor allows the lessee to use property for a predetermined period of time in exchange for the lessee's obligation to return the property at the end of the lease and to make rent payments for the duration of the lease term (*see* Graphic 6).

Characterization as a lease has some appeal. Consistent with a lessor, the cryptocurrency lender does not intend to divest itself of the economics of ownership and, like a lessee, the cryptocurrency borrower pays a fee for the use of the cryptocurrency during the period which amount is based on that cryptocurrency's fair market value, and upon termination is obliged to return the same amount

GRAPHIC 6. DIAGRAM OF A LEASE



and type of cryptocurrency that was transferred at the outset. Similar to a bailment, characterization as lease seems to be the correct tax result provided the lease's terms are substantially similar to the subordination agreement in *Stahl* and *Miami National Bank,* described above. However, in many cryptocurrency loans the borrower has a right to dispose of the cryptocurrency lent without holding an equivalent amount of cryptocurrency on hand. In such cases, lease characterization may be inapt because it presupposes that tax ownership is not transferred pursuant to the cryptocurrency loan. *Grodt & McKay* and similar authorities on the taxation of leases have consistently held that a purported lease will be recharacterized if tax ownership of the leased property is transferred. In light of the authorities described above on the tax ownership of fungible and liquid properties, it seems unlikely that lease characterization or bailment for profit treatment could be sustained where the lessee has unfettered right to dispose of the cryptocurrency, in fact does so, and the lessor is otherwise unable to establish that the units of cryptocurrency returned are the same units initially transferred notwithstanding the fact that all units of the cryptocurrency are identical and indistinguishable from any other unit of cryptocurrency.

Conclusion

Where does this leave us? The common thread in the authorities described above is that tax ownership will be the primary determinant of the tax treatment of a property loan. The ability to dispose of the property is the most significant, and in some cases overriding, determinant of tax ownership for liquid and fungible assets. Consequently, it seems fairly clear that the typical cryptocurrency loan transfers ownership from the cryptocurrency lender to the cryptocurrency borrower. This would seem to rule out the bailment and lease analogies unless the terms of the cryptocurrency loan are carefully crafted and implemented.

But while tax ownership appears to be transferred, it seems the better answer is that the resulting exchange does not give rise to the realization of a gain or loss. Only the foreign currency loan analogy could potentially give rise to gain or loss, but this analogy should be rejected because of the significant differences in purpose and economics of foreign currency loans and cryptocurrency loans, and for the other reasons described above. This leaves two alternative approaches. In the first approach ("Approach 1"), a cryptocurrency loan results in the exchange of a cryptocurrency for an identical cryptocurrency that will be received in the future. In the second approach ("Approach 2"), the cryptocurrency is treated as being exchanged for a contractual obligation to return cryptocurrency, this initial exchange is then followed by a second exchange where the contractual obligation is exchanged for cryptocurrency. In both cases, the materially different requirement is not met (and thus there is no taxable event) because the property received is either identical cryptocurrency (Approach 1) or a contractual obligation that does not differ materially in kind or extent (Approach 2).

We think this result is supported by the relevant policy considerations. Congress enacted Code Sec. 1058 to support liquidity in the stock and securities markets and we see no reason why the cryptocurrency markets would be any different. In addition, if future guidance were to take the position that a cryptocurrency loan resulted in the realization of gain or loss, taxpayers could be tempted to use cryptocurrency loans to harvest losses without divesting any of the underlying economics of cryptocurrency ownership. It is not clear that the wash sale rules are sufficient to prevent this opportunity for abuse, which would be especially present in the cryptocurrency markets due to their ever-present volatility.[65]

We close with a word of caution—the foregoing considers only the taxation of the "typical" cryptocurrency loan described at the beginning of this article (*i.e.*, one structured in manner that meets the requirements of Code Sec. 1058(b) and the five-day rule). If a cryptocurrency lender cannot terminate the transaction within a reasonable notice period or if other circumstances result in the transfer of the opportunity for gain or the risk of loss, a different tax treatment may be warranted. For example, it is not clear that a fixed term cryptocurrency loan would constitute a non-taxable transaction. If the proposed Code Sec. 1058 regulations were applied by analogy, it certainly would not. However, those regulations are not currently effective and have been the subject of significant criticism; the non-taxability of a fixed term cryptocurrency loan would be consistent with positions taken by securities lenders; and non-taxability would arguably be supported by *Starker* (which dealt with a five-year deferred exchange) and the pre-Code Sec. 1058 guidance (which also rely on the concept of a deferred exchange).[66] The underlying cryptocurrency might also factor into whether a particular cryptocurrency loan gives rise to taxable gain or loss. For example, a cryptocurrency whose value is tied to the value of a fiat currency (*i.e.*, a "stable coin") may present economics more akin to foreign currency and might therefore warrant a closer inspection of the foreign currency analogy. But these questions are for a different day. For now, it suffices to say that any "coloring outside the lines" of the typical cryptocurrency loan will carry with it some incremental tax uncertainty.

ENDNOTES

1 *See bitcoin.org/bitcoin.pdf*.

2 For example, some market participants borrow cryptocurrency as part of a market arbitrage opportunity to capture price dislocation for a cryptocurrency trading in different markets or on different exchanges. An example is the periodic price disparity between bitcoin traded on South Korean crypto exchanges versus on U.S. crypto exchanges *www.coindesk.com/bitcoins-kimchi-premium-vanishes-again-as-trading-range-tightens.*

3 There may, of course, exist non-typical cryptocurrency loans, which may operate differently and thus pose different tax issues than those covered in this article.

4 *See, e.g.,* Notice 2004-52 (outlining four possible characterizations of credit default swaps for purposes of determining the tax rules to apply to credit default swaps); Paul Kunkel, *Reverse Convertibles*, 7(2) J. Tax'n of Fin. Prods., 15 (2008) (describing reversible convertibles and the possible ways that they could be taxed).

5 Reg. §1.1001-1(a).

6 *See Grodt & McKay Realty, Inc.*, 77 TC 1221, 1237, Dec. 38,472 (1981) ("The key to deciding whether [buyer's] transactions with [seller] are sales is to determine whether the benefits and burdens of ownership have passed from [seller] to [buyer]."); *United Surgical Steel Co., Inc.*, 54 TC 1215, 1229, Dec. 30,160 (1970) ("We think it is obvious that a disposition involves the relinquishment of the substantial incidents of ownership of the [sold property]."); *Illinois Power Co.*, 87 TC 82 (1986) (seller retained benefits and burdens of ownership in the sold property, and as a result, transaction was viewed by court as a financing rather than a sale).

7 *Grodt & McKay Realty*, 77 TC 1221, Dec. 38,472 (1981).

8 *Id*, 1237–1238.

9 *See E. Torres*, 88 TC 702, 721, Dec. 43,809 (1987) ("In analyzing the transaction in this case, we first note that some of the factors enumerated in [*Grodt & McKay*] … are either less relevant in this case or must be considered in a different light because the transaction under consideration in that case did not include a leaseback of the subject property. Hence, because net leases are common in commercial settings, it is less relevant that petitioner was not responsible for the payment of property taxes or that petitioner bears less of a risk of loss or damage to the property because the lessee is required to maintain insurance on the property. Similarly, a lessor is normally not vested with the right of possession during the term of the lease and, therefore, the relevant consideration in this regard is whether the useful life of the property extends beyond the term of the lease so as to give the purchaser a meaningful possessory right in the property. Also, in a leaseback transaction it is normal for the lessee to receive profits from the operation of the property while the lessor's receipt of payments is less dependent upon the operation of the property."). *See also* FSA 200201022 (Oct. 4, 2001); FSA 200106019 (Feb. 12, 2001).

10 Informal guidance implies that borrow fees are not properly treated as interest. *See* LTR 8822061 (Mar. 7, 1988) (borrow fees were "industrial or commercial profits"). This is consistent with previous guidance that a securities loan does not constitute indebtedness. *See Deputy v. Dupont*, SCt, 40-1 USTC ¶9161, 308 US 488, 497, 60 SCt 363.

11 *G.D. Provost*, SCt, 1 USTC ¶153, 269 US 443, 46 SCt 152.

12 *See Richardson v. Shaw*, 209 US 365 (1908).

13 *G.D. Provost*, SCt, 1 USTC ¶153, 269 US 455, 46 SCt 152.

14 The opinion does acknowledge that the short seller is expected to post collateral with the securities lender in amount equal to the fair market value of the lent securities.

15 *G.D. Provost*, SCt, 1 USTC ¶153, 269 US 456, 46 SCt 152.

16 *See* Alex Raskolnikov, *Contextual Analysis of Tax Ownership* (Feb. 3, 2014) *tax.network/araskolnikov/contextual-analysis-tax-ownership* ("The analysis could not have been clearer: a pledger does not become a tax owner of a pledged stock while a stock borrower does become a tax owner of a borrowed stock because the pledger has a limited control over the pledged securities while the stock borrower's control is complete. This result obtains even though a stock borrower gains no economic exposure to the borrowed stock, all of which is retained by a lender. *In other words, control overrides economic exposure in determining tax ownership of a borrowed stock*.") (emphasis added); Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783, 793 (1993) ("The key economic factor in determining whether an investor owns a security for gain/loss realization purposes is whether that investor had the freedom to dispose of that security (*i.e.*, to convey *both* legal title and market risks and opportunities) to an outright purchaser. This proposition is succinctly illustrated by contrasting the facts of *Richardson v. Shaw* and *Provost v. United States*.") (emphasis in the original); David S. Miller, *Taxpayer's Ability to Avoid Tax Ownership: Current Law and Future Prospects*, 51 Tax Law 279, 295 (1988) ("[U]nder these authorities a taxpayer is no longer the tax owner of securities that are loaned pursuant to an agreement that legally and practically deprives the lender of title and all right to receive back the specific securities transferred (and conversely, these authorities permit the borrower to transfer legal title to and all beneficial interest in those specific securities to a third party transferee)."); John Kaufmann, *Caveat Re-Emptor*, 15(1) J. Tax'n of Fin. Prods. 17 (2017) ("The weight placed on the remaining factors varies depending on whether the asset at issue is a liquid asset or an illiquid asset. In the case of liquid assets, such as publicly traded securities and certain fungible commodities, courts and the IRS generally look to the identity of the party who controls the disposition of the asset to determine the identity of the beneficial owner rather than to the intent of the parties or

the identity of the party who bears the 'burdens and benefits' of ownership. This rule tends to be counter-intuitive because it is arrived at by process of elimination; nevertheless, it is the only rule that makes sense in this context. Economic exposure to a liquid asset is not sufficient to identify the unique tax owner thereof because there may be infinitely many long positions that grant 'delta one' exposure to the asset, but there can only be one tax owner.")

[17] Absent this one owner principle, parties could use contracts that provide economic exposure to multiple certain beneficial income streams. For example, if economic exposure were treated as tax ownership, multiple parties could benefit from a dividends received deduction on the same stock dividend. Similarly, only the owner of a municipal bond is entitled to exclude tax-exempt interest from taxable income, even though multiple parties may have economics that mimic direct ownership in the bond. *See, eg, Nebraska Department of Revenue v. Loewenstein*, SCt, 513 US 123, 115 SCt 557 (1994) ("We do not believe it matters for purposes of §3124(a) whether the repo is characterized as a sale and subsequent repurchase. A sale-repurchase characterization presumably would make the Trusts the 'owners' of the federal securities. … [b]ut the dispositive question is whether the Trusts earned interest on 'obligations of the United States Government,' not whether the Trusts 'owned' such obligations … The substance and economic realities of the Trusts' repo transactions, as manifested in the specific facts discussed above, are that the Trusts do not receive either coupon interest or discount interest from federal securities by participating in repos. Rather, in economic reality, the Trusts receive interest on cash they have lent to the Seller-Borrower.")

[18] Rev. Rul. 57-451, 1957-2 CB 295.

[19] *See* note 15 and accompanying text.

[20] Code Sec. 1036(a).

[21] GCM 36948 (Dec. 10, 1976).

[22] S. Rep. No. 95-762, 7 (1978) (emphasis added).

[23] It may be that this distinction was inadvertent, as Congress also indicated that Code Sec. 1058 was a "clarification" of the pre-section 1058 guidance. S. Rep. No. 95-762, 7 (1978) ("[T]he committee has concluded that it is desirable to clarify existing law as to the appropriate tax treatment of lenders of securities generally."). This clarification was likely prompted by inconsistencies between the guidance described above and a private letter ruling addressed to the New York Stock Exchange, dated April 19, 1948 that took the position that a securities lending transaction did not constitute a taxable disposition of the loaned securities and that the transaction did not interrupt the lender's holding period (which would imply that a securities lending transaction did not result in an exchange). It also bears noting that the legislative history also cites Rev. Rul. 57-451 and gives no indication that this guidance was inappropriate or flawed in its reasoning. *Id.*, 1289.

[24] *Supra* note 22.

[25] Proposed Reg. §1.1058-1(b)(3).

[26] *See, e.g.,* Risk Management Association, *Recommendations for the 2019-2020 Priority Guidance Plan*, 2019 TNTF 157–36 (2019) (describing fixed-term securities loans with terms varying from 30 days to up to 1 year).

[27] *See H. Samueli*, 132 TC 37, 49, Dec. 57,759 (2009) (while acknowledging that Code Sec. 1058(b)(3) itself does not "require explicitly that a securities loan be terminable within a set period akin to the 5-day period", the Tax Court concluded the law at the time required a five-day termination period and Congress intended for this standard to be incorporated into Code Sec. 1058); *A.L. Calloway*, 135 TC 26, 44, Dec. 58,264 (2010) ("In order to meet the requirements of section 1058(b)(3), the agreement must give the person who transfers stock all of the benefits and burdens of ownership of the transferred securities and the right to "be able to terminate the loan agreement upon demand.") (quotations omitted).

[28] *See H. Samueli*, CA-9, 2011-2 USTC ¶50,697, 661 F3d 399, 410.

[29] Proposed Reg. §1.1058-1(e)(1).

[30] *See, e.g., ABA Committee Reports on Securities Lending Transactions*, 91 TNT 107–133 (May 15, 1991) ("In general, *Section 1058(a)* provides that no gain or loss is recognized by the owner of securities when the owner transfers securities for the contractual obligation of the borrower to return identical securities. It constitutes a safe harbor from the recognition of gain or loss where a taxpayer exchanges securities pursuant to an agreement that meets the statutory requirements."); *NYSBA Tax Section Report Addresses Treatment of Securities Loans*, 2011 TNT 112–122 (June 10, 2011) ("There is nothing in the language of [section 1058] itself or the history of the statute to suggest that it was intended to be more than a safe harbor. … In our view, section 1058 should operate as a safe harbor.").

[31] It is not clear whether most cryptocurrency loans require collateral to be posted by the cryptocurrency borrower, as is typical in a securities lending transaction. If a cryptocurrency borrower does not post collateral, it may be more difficult to sustain a position that the risk and opportunity requirement is met because the cryptocurrency lender would have greater exposure to credit risk. With that said, neither the statute nor the proposed Code Sec. 1058 regulations contain a requirement that collateral be posted and the legislative history can be read to suggest that Congress contemplated some unsecured securities lending transactions to qualify under Code Sec. 1058. *See* S. Rep. No. 95-762, 4 ("In most cases, the loan of securities is fully collateralized (with adjustments made on a daily basis) by cash or marketable securities having a fair market value not less than the fair market value of the securities loaned. *However, no collateral is provided if securities are borrowed from margin accounts*.") (emphasis added). Further, the posting of collateral might actually increase the possibility that a cryptocurrency loan would be treated as a sale under other authorities. *See infra* note 39 and accompanying text.

[32] Code Sec. 1058(a).

[33] *See supra* note 22.

[34] *See supra* note 30.

[35] *See NYSBA Tax Section Report Addresses Treatment of Securities Loans*, 2011 TNT 112-22 (June 10, 2011) ("We would recommend that the definition of "securities" be broadened to include all instruments that are publicly traded and that are susceptible to being loaned on conditions otherwise meeting the requirements of section 1058. We see no policy reason for drawing a distinction between instruments that qualify as securities under section 1236(c) and those that do not. Although the reference to section 1236(c) is contained in the statutory language of section 1058, we note that the statute was enacted in a time when there were many fewer types of publicly traded property than there are in the current markets, and believe that the reference to 1236(c) is more likely an historical accident than the reflection of a conscious policy choice. In any event, even if Treasury and the IRS were to take the view that there is no authority under section 1058 to expand the definition of "securities," we believe that it would be appropriate to apply nonrecognition status to loans of publicly-traded property under the interpretation of Treasury regulation section 1.1001-1(a)").

[36] *T.J. Starker*, CA-9, 79-2 USTC ¶9541, 602 F2d 1341 (1979). *See also* Rev. Rul. 61-119, 1961-1 CB 395 (1961); *Redwing Carriers, Inc. v. Tomlinson*, CA-5, 68-2 USTC ¶9540, 399 F2d 652.

[37] The court also addressed the treatment of the growth factor and determined that it was "disguised interest." *T.J. Starker*, CA-9, 79-2 USTC ¶9541, 602 F2d 1356. If the term interest was used in the literal sense, it is somewhat difficult to reconcile this conclusion with the conclusion that the transaction represented an exchange of like-kind properties rather than an exchange of timberland for a debt instrument. *Cf. Deputy v. Dupont*, SCt, 40-1 USTC ¶9161, 308 US 488, 497, 60 SCt 363 (1940). However, it is possible that the court simply intended to demonstrate that the growth factor was not in the nature of a capital gain (as the taxpayer had contended) because it was economically similar to an interest charge.

[38] *See C. Bean Lumber Transp., Inc.*, 68 F Supp 2d 1055 (W.D. Ark. 1999).

[39] *See* Act Sec. 13303 of Tax Cuts and Jobs Act (P.L. 115-97) (limiting Code Sec. 1031 to exchanges of real property).

[40] *Cf.* GCM 36948 (Dec. 10, 1976) ("In the typical case where the broker-dealer satisfies his contractual

obligation by delivering securities not differing materially in either kind or extent, there will be no realization of gain or loss under Code §1001 because of Treas. Reg. §1.1001-1(a) ... Accordingly, the exchange will be nontaxable since there is no gain which could be taxed in any event, thus obviating the need to apply a specific statutory provision such as Code §1036 so as to afford nonrecognition treatment for gain or loss realized.").

41 Code Sec. 1031(a)(3).

42 *See supra* note 26.

43 *Cf.* Code Sec.163(l)(3)(A) (limits the deductibility of interest, but does not recharacterize as equity, certain debt instruments for which a substantial amount of the principal or interest is required to be paid in equity); Reg. §1.1275-4(b)(7)(vi) Ex. 1 (contingent payment debt instrument only guaranteed a return of 97.5 percent of the amount invested, while this example was coupled with "no inference" language it seems highly doubtful that the Treasury Department would have included an example that they believed violated a fundamental principle of the income tax law).

44 *See also B. Gilbert*, CA-2, 59-1 USTC ¶9183, 248 F2d 399, 402 ("The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."); *B. Gilman*, CA-8, 2 USTC ¶801, 53 F2d 47, 50 ("The term indebtedness as used in the Revenue act implies an unconditional obligation to pay." (quotations omitted)).

45 FSA 199940007 (Oct. 8, 1999).

46 Reg. §1.988-2(a)(2). *See also KVP Sutherland Paper Co.*, CtCls, 65-1 USTC ¶9358, 344 F2d 377 (a loan of foreign currency involves three recognition events: (1) the exchange of foreign currency for a note, (2) the receipt of foreign currency on repayment, and (3) the conversion of the foreign currency received on repayment to U.S. dollars).

47 Reg. §1.988-2(b)(5).

48 Notice 2014-21, 2014-16 IRB 938.

49 *See* Financial Crimes Enforcement Network (FinCEN), Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (FIN-2013-G001, Mar. 18, 2013). *See also* Notice 2014-21, § 2.

50 In fact, different characterizations may be contrary to the statute in some cases. *See* Code Sec. 385(c)(1) (requiring holders to characterize an interest in a corporation as a debt instrument or non-debt instrument in a manner consistent with the issuer's characterization).

51 Obviously, loans denominated in nonfunctional currency to both parties do exist. However, those situations are the exception rather than the rule, and were likely not a significant factor in the development of the foreign currency lending statutory regime.

52 *B.F. Goodrich*, 1 TC 1098, Dec. 13,187 (1943) (repayment of French franc denominated loan with depreciated currency did not give rise to taxable income); *Coverdale*, 4 TCM (CCH) 713, Dec. 14,659(M) (1945) (repayment of Canadian dollar denominated loan with depreciated currency did not give rise to taxable income); *North American Mortgage Company*, 18 BTA 418, Dec. 5676 (1929), *acq. withdrawn, nonacq., IRS Announcement Relating to: N. Am. Mortg. Co.* (Dec. 31, 1955) (repayment of guilder denominated loan with depreciated currency did not give rise to taxable income); *R. Bohm*, 34 TC 929, Dec. 24,323 (1960) (repayment of British pound denominated loan with appreciated currency did not give rise to taxable loss). *See also* Donald R. Ravenscroft, *Taxation of Income Arising from Changes in Value of Foreign Currency*, 82 HARV. L. REV. 772, 774–777 (1969) (discussing arguments for non-taxability of foreign currency denominated loans).

53 *See, e.g., J.A. Gillin*, CtCls, 70-1 USTC ¶9341, 423 F2d 309, 314 (discharge of indebtedness in Canadian dollars at a lesser amount of United States dollars than the Canadian dollars were originally converted into, resulted in ordinary income); *Bennett's Travel Bureau, Inc.*, 29 TC 350, 359, Dec. 22,671 (1957) (discharge of indebtedness in Norwegian kroner at less than face value following devaluation resulted in ordinary gain); *America-S.E. Asia Co.*, 26 TC 198, 200, Dec. 21,700 (1956) (discharge of indebtedness in pounds sterling at less than face value resulted in ordinary gain); *Church's English Shoes, Ltd.*, 24 TC 56, 59, Dec. 20,969 (1955) (discharge of pounds sterling debt resulted in ordinary gain); *Willard Helburn, Inc.*, 20 TC 740, 744, Dec. 19,783 (1953) (discharge of indebtedness in pounds sterling at a lower cost in U.S. dollars than the original value of the loan in U.S. dollars, resulted in taxable income). *See also* Donald R. Ravenscroft, *Taxation of Income Arising from Changes in Value of Foreign Currency*, 82 HARV. L. REV. 772, 777–779 (1969) (discussing arguments for taxability of foreign currency denominated loans).

54 *R. Bohm*, 34 TC 929, Dec. 24,323 (1960).

55 *See, e.g., Philip Morris Inc.*, 104 TC 61, 75 (1995), *aff'd*, CA-2, 96-1 USTC ¶50,007, 71 F3d 1040.

56 *B.F. Goodrich*, 1 TC 1098, 1103, Dec. 13,187 (1943) (citing *Gen. Motors Corp.*, 35 BTA 523, 526, Dec. 9587 (1937) as support for rejecting the short sale analogy); *National Standard Co.*, 80 TC 551, 567, Dec. 39,969 (1983), *aff'd sub nom.*, *National Standard Co.*, CA-6, 84-2 USTC ¶10,001, 749 F2d 369 (see Dawson concurrence and Tannenwald dissent); *America-S.E. Asia Co.*, 26 TC 198, 200, Dec. 21,700 (1956) (the court observed that there is a marked similarity between transactions in foreign currencies and short sales); *Gillin*, CtCl, 70-1 USTC ¶9341, 423 F 2d 309, 312 (the Court of Claims did not reject the short-sale analogy but also rested its decision on another basis).

57 *See, e.g.*, Roberts, *Borrowings in Foreign Currencies*, 26 TAXES 1033 (1948); Thomas G. Ross, *Tax-Treatment Accorded Foreign Currency Debt Redemption Gains and Losses: National-Standard Co. v. Commissioner*, 9 J. CORP. L. 951 (1984).

58 *KVP Sutherland Paper Co.*, CtCls, 65-1 USTC ¶9358, 344 F2d 377.

59 *R.S. Stahl*, CA-DC, 70-2 USTC ¶9714, 441 F 2d 999, *aff'g* DC-DC, 70-2 USTC ¶9714, 294 F Supp 243.

60 *Stahl*, 294 F. Supp. at 244. *See also, Miami National Bank*, 67 TC 793, Dec. 34,251 (1977). Miami National Bank concerned whether a corporate taxpayer "owned directly" a sufficient amount shares of a subsidiary for purposes of the consolidated tax group rules in Code Sec. 1504(a). Certain shares of the subsidiary were held in a subordinated securities account maintained by a broker and were subject to a subordination agreement. The shares held pursuant to the subordination agreement enabled the broker to take the shares into account in meeting the broker's net capital requirement of rule 325 of the New York Stock Exchange an also enabled the broker to dispose the shares for the benefit of broker's creditors in the event of "financial difficulties." In exchange, the bailor was paid a periodic fee for use of the shares. In addition, prior to broker's financial difficulties, the subordination agreement permitted the bailor to (i) substitute the shares in the subordination account for cash or other marketable securities or equivalent value which the taxpayer in fact exercised, (ii) to vote the shares, and (iii) to have all dividends paid thereon to be credited to the subordination account. The court concluded that the bailor retained tax ownership of the shares.

61 GCM 35183 (Jan. 2, 1973).

62 *See also Sturm v. Boker*, 150 US 312, 329 (1893) ("The recognized distinction between bailment and sale is that when the identical article is to be returned in the same or in some altered form, the contract is one of bailment, and the title to the property is not changed. On the other hand, when there is no obligation to return the specific article, and the receiver is at liberty to return another thing of value, he becomes a debtor to make the return, and the title to the property is changed; the transaction is a sale.").

63 *See also* GCM 37063 (Mar. 25, 1977); GCM 37064 (Mar. 25, 1977).

64 Most cryptocurrencies, save a few, lack a unique serial number like that associated with paper money, stock certificates, and certain securities. Nonetheless, it is possible to identify a particular unit or pool of cryptocurrency initially transferred and then later returned as the same cryptocurrency absent serial numbers by use of a segregated wallet and the wallet's transactional history which typically includes the date, time, and amount, and source of cryptocurrency deposited therein and the same information in respect of any cryptocurrency withdrawal therefrom. Identifying cryptocurrency by this approach is common where the cryptocurrency is transferred to a lender as a pledge of collateral, for example to secure repayment of a cash loan or to provide a guarantee.

65 In informal guidance the government has taken the position that the definition of a security

for wash sale purposes should align with the Code Sec. 1236(c) definition of a security which, as discussed above, is unlikely to encompass cryptocurrencies. *See* GCM 39551 (June 30, 1986) ("We believe that the definition of securities for section 1092 should be identical to the definition of securities in section 1091. Accordingly, we view Temporary Reg. §1.1092(b)-5T(g) as defining the term 'securities' in section 1091 with reference to the definition of 'securities' in section 1236(c)."). *But see* Rev. Rul. 77-185, 1977-1 CB 48 (artificial loss of a nonsecurity disallowed).

[66] Taxpayers seeking greater certainty might consider limiting fixed-term cryptocurrency loans to more than 180 days as this is the standard Congress set forth when amending Code Sec. 1031.