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IRS Publishes Advice Concerning Cryptocurrency that has Declined in Value

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On January 13, 2023, the Internal Revenue Service (IRS) Office of Chief Counsel published Memorandum 202302011 titled "[a]pplicability of I.R.C. section 165 to cryptocurrency that has declined in value." [1] The Memorandum contains "advice regarding the applicability of section 165 of the Internal Revenue Code ("Code") to cryptocurrency that has substantially declined in value." [2] The Memorandum makes clear that the proffered advice "should not be used or cited as precedent." [3]

The Memorandum addresses the specific question, "[i]f Taxpayer A owns cryptocurrency that has substantially declined in value, has Taxpayer A sustained a loss under section 165 of the Code due to worthlessness or abandonment of the cryptocurrency?" [4] In its responsive advice, the IRS concludes that,

> No. Section 165 provides a deduction for losses that are evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Taxpayer A has not abandoned or otherwise disposed of the cryptocurrency, and the cryptocurrency is not worthless because it still has value. Therefore, Taxpayer A has not sustained a loss under section 165 and the corresponding regulations. Further, even if Taxpayer A sustained a loss under section 165, the loss would be disallowed because section 67(g) suspends miscellaneous itemized deductions for taxable years 2018 through 2025.[5]

Memorandum 202302011 provides a detailed Discussion concerning cryptocurrency that has declined in value. Perhaps most notably, the Memorandum specifically addresses "Worthless Cryptocurrency" and "Abandoned Cryptocurrency."

I. Worthless Cryptocurrency and Abandoned Cryptocurrency

The Discussion of both Worthless Cryptocurrency and Abandoned Cryptocurrency concerns a hypothetical "Cryptocurrency B" addressed in the Memorandum's Facts. [6] "Cryptocurrency B," among other things, was "purchased at $1.00 per unit for personal investment purposes on a cryptocurrency exchange [… ,] the per unit value of Cryptocurrency B decreased significantly, such that each unit of Cryptocurrency B was valued at less than one cent at the end of 2022[, o]n December 31, 2022, Cryptocurrency B continued to be traded on at least one cryptocurrency exchange, and Taxpayer A maintained dominion and control over the units of Cryptocurrency B[… .]" [7]

a. Worthless Cryptocurrency

As noted in the fact pattern, Cryptocurrency B has substantially decreased in value. That said the value of Cryptocurrency B was still "greater than zero, it continued to be traded on at least one cryptocurrency exchange, and [Taxpayer A] did not sell, exchange, or otherwise dispose of the units of Cryptocurrency B." [8] The Memorandum notes, in part, that "'[1.] the mere diminution in value of property does not create a deductible loss[, 2. a]n economic loss in value of property must be determined by the permanent closing of a transaction with respect to the property [and, 3. a] decrease in value must be accompanied by some

affirmative step that fixes the amount of the loss, such as abandonment, sale, or exchange." [9] Additionally, "[a] loss may be sustained, […] if a cryptocurrency becomes worthless, resulting in an identifiable event that occurs during the tax year for purposes of section 165(a)."[10]
The Memorandum determines that because "[…] each unit of Cryptocurrency B had liquidating value, though it was valued at less than one cent at the end of 2022 [… and c]ryptocurrency B continued to be traded on at least one cryptocurrency exchange, allowing for the possibility that it may increase in value in the future [… ,] Cryptocurrency B was not wholly worthless during 2022 as a result of its decline in value, and Taxpayer A did not sustain a bona fide loss under section 165(a) in 2022 due to worthlessness."[11]

b. Abandoned Cryptocurrency

The Memorandum notes that, "a taxpayer sustains a loss under section 165(a) for the obsolescence or loss of usefulness of nondepreciable property if: '(1) the loss is incurred in a business or a transaction entered for profit; (2) the loss arises from the sudden termination of usefulness in the business or transaction; and (3) the property is permanently discarded from use, or the transaction is discontinued." [12]
The Memorandum ultimately concludes, despite the value of each unit of the cryptocurrency being less than one cent at the end of the year, that because "[…]Taxpayer A retained the ability to sell, exchange, or otherwise dispose of Cryptocurrency B during 2022 [… and] continued to exert dominion and control over Cryptocurrency B [without taking] any affirmative steps to abandon the property during 2022 [… ,]Taxpayer A did not sustain a loss pursuant to section 165(a) in 2022 due to abandonment."[13]

II. Digital Assets Terminology

Of additional interest as it relates to the broader federal development of Foundational Digital Assets Terminology, the Memorandum provides informative definitions concerning digital assets, cryptocurrency, and other relevant terms. For example, the Memorandum states,

> Digital assets are defined under section 6045(g)(3)(D) as digital representations of value that are recorded on a cryptographically secured distributed ledger. Digital assets do not exist in physical form and include, but are not limited to, property the Service has previously referred to as convertible virtual currency and cryptocurrency. See Notice 2014-21, 2014-16 I.R.B. 938; Rev. Rul. 2019-24, 2019-44 I.R.B. 1004. Notice 2014–21 provides that convertible virtual currency is treated as property and that general tax principles applicable to property transactions apply to convertible virtual currency.
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> Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Units of cryptocurrency are generally referred to as coins or tokens. Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality. See Rev. Rul. 2019-24.[14]

As digital assets (which includes cryptocurrency, stablecoin, and central bank digital currency (CBDC)) regulation and legislation continues to develop in 2023, it will be important to follow how the IRS and other relevant federal entities address related issues and topics.

Kilpatrick Townsend's Digital Assets Regulation Blog

Kilpatrick Townsend's Digital Assets Regulation Blog (DARB) covers various aspects of digital assets regulation, development, and administration, as well as related topics. For more information, please visit our website at Digital Assets Regulation (kilpatricktownsend.com).

Footnotes

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[1] I.R.S. C. Couns. Mem. 202302011 at 1 (Jan. 1, 2023).
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] *Id.* at 2.
[7] *Id.*
[8] *Id.* at 3.
[9] *Id.*
[10] *Id.* at 3-4.
[11] *Id*. at 4.
[12] *Id*.
[13] *Id*. at 5.
[14] *Id.*