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# Specifically Identifying Exchange-Based Crypto: An Old Solution to a New Problem

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## INTRODUCTION

Specific identification is currently the only authorized method for computing the cost basis of cryptocurrency. For crypto held in personal wallets[1] and sold in peer-to-peer transactions, cost basis must be computed by specifically identifying the purchase price of particular coins sold by the taxpayer. Nonetheless, given its fungible nature, it is often difficult, if not impossible, for tax practitioners to apply this method to exchange-based crypto sold by their clients. As a result, although not technically authorized, many practitioners take the practical approach of using other generally accepted cost basis methods such as first-in, first-out (FIFO) or average cost. Unfortunately for taxpayers, these other methods provide less flexibility in computing cost basis and, in turn, typically result in higher capital gains in early years.

With proper planning, tax practitioners should be able to compute the cost basis of exchange-based crypto under the specific identification method. In particular, it may be possible to identify and contemporaneously document the dates and purchase prices of particular exchange-based crypto sold by a taxpayer in a manner the courts will deem adequate. In so doing, practitioners may be able to limit their clients' capital gains in early years by facilitating the sale of the highest, like-amounts of exchange-based crypto first.

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[1] A cryptocurrency wallet is a software program that securely stores private and public keys and enables users to send and receive digital currency and track crypto ownership.

## ANALYSIS

The Internal Revenue Service addressed the taxation of crypto transactions in Notice 2014-21, concluding that crypto should be treated as property for federal tax purposes.[2] Nonetheless, rather than creating new crypto-specific rules and regulations, the IRS indicated that general tax principles applicable to property transactions should be applied.

Notice 2014-21 states that, with respect to capital assets,[3] taxpayers recognize gain or loss on the sale or exchange of crypto for other property. Reg.§1.61-6(a) defines gain as the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. Section 1011 characterizes the term "cost or other basis" as adjusted basis. Section 1012, in turn, states that the adjusted basis of property sold or exchanged shall be the cost of the property unless otherwise specified. This method of determining basis is more commonly known as specific identification. No other rules concerning the basis of crypto held as a capital asset are specified in the Code, regulations, or IRS publications.

For taxpayers who hold the private keys to their coins in personal wallets and sell particular coins in peer-to-peer transactions, it should not be overly difficult to determine the actual cost of the coins sold in

[2] Neither the IRS nor the courts have further classified crypto as a particular type of property for tax purposes. This is not to say that the courts and other government agencies have not classified crypto in other contexts. For example, a federal district court judge found that crypto is a commodity for the purposes of Commodity Futures Trading Commission (CFTC) jurisdiction. *See CFTC v. McDonnell*, 287 F. Supp.3d 213 (E.D.N.Y. 2018), where the court reasoned that "virtual currencies are 'goods' exchanged in a market for a uniform quality and value . . . ." Moreover, in a recent interview with CNBC, the Chairman of the Securities and Exchange Commission (SEC) stated, with respect to crypto tokens, that "a digital asset, where I give you my money and you go off and make a venture, and in return for giving you my money I say 'you can get a return' that is a security and we can regulate that." Kate Rooney, *SEC chief says agency won't change securities laws to cater to cryptocurrencies*, CNBC (June 6, 2018).

[3] *See* §1221; Capital assets are a type of property defined by the Code in the negative. Of the enumerated categories of non-capital assets, only two are generally applicable to crypto assets held as inventory and hedging transactions. This article does not address the taxation of crypto held as non-capital assets. All section references are to the Internal Revenue Code of 1986 (Code), as amended, or the Treasury regulations thereunder, unless otherwise specified.

these transactions. Even if the taxpayer does not maintain or have access to contemporaneous records, the dates of coin transactions should be traceable in the blockchain with the coin's public key and can be valued using historical coin pricing charts. Because the actual cost of particular coins sold in peer-to-peer transactions typically can be specifically identified, courts will likely require taxpayers to compute cost basis this way.

On the other hand, for taxpayers who utilize custodial exchanges such as Coinbase to hold and sell crypto coins, it is decidedly more difficult to compute cost basis using the specific identification method. Unlike personal wallets, wallets provided by custodial exchanges typically do not hold particular coins or their corresponding private keys for users.[4] To the contrary, these wallets typically hold fungible value that corresponds to a coin in the exchange's own inventory. To that end, when a taxpayer transfers a coin into such a wallet, they likely transfer possession and ownership to the exchange along with it. Upon this transfer, the exchange receives a private key for the coin and adds it to its own inventory. In return, the exchange credits the user's account with the coin's fungible value. When users purchase coins on a custodial exchange using fiat or buy and sell coins from other users, the transaction is not recorded in the blockchain.[5] Instead, for each, the exchange simply updates its internal records to reflect the transfer of fungible value among the user wallets.[6]

While specific identification is the only authorized method of computing crypto cost basis, the fungible nature of coin sales on custodial exchanges frustrates taxpayers' ability to apply this method. Because taxpayers do not sell particular coins on these exchanges, they cannot easily identify the costs of what they sold. Recognizing this problem, many practitioners advise their clients to use other cost basis methods such as FIFO and average cost. This advice is generally not based on any statute or regulation explicitly permitting this method for crypto. Rather, it is based on practical reasoning that the IRS accepts these methods for other capital assets such as corporate stock and that, because they are not the most financially advantageous methods for the taxpayer, the IRS is unlikely to challenge such treatment. This is sound advice for situations in which fungible crypto has already been sold on an exchange without a contemporaneous record of what particular crypto the taxpayer sold. However, with proper planning, taxpayers may be able to compute the cost basis of fungible crypto in a more favorable and legally supportable manner.

While the issue of how to specifically identify fungible property is new to crypto, there is over a century's worth of case law and regulatory responses for dealing with cost basis computation issues for another type of fungible property—stock in corporations. With no virtual currency-specific statutory or regulatory guidance, courts are likely to look to this analogous body of law to determine how taxpayers can calculate crypto basis.

Reg. §1.1012-1(c) contains specific rules for determining the cost basis of fungible corporate stock.[7] These rules state that if a taxpayer cannot adequately identify the cost basis, it should be computed on a FIFO basis.[8] To that end, the rules also provide several safe harbors for specifically identifying the purchase price of fungible corporate stock.[9] The safe harbors in Reg. §1.1012-1(c)(3) deem the following methods to constitute adequate identification:

> (i) Where the stock is left in the custody of a broker or other agent, an adequate identification is made if:
>
> (a) At the time of the sale or transfer, the taxpayer specifies to such broker or other agent having custody of the stock the particular stock to be sold or transferred; and
>
> (b) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or other agent.
>
> Stock identified pursuant to this subdivision is the stock sold or transferred by the taxpayer, even though stock certificates from a different lot are delivered to the taxpayer's transferee.
>
> (ii) Where a single stock certificate represents stock from different lots, where such certificate is held by the taxpayer rather than his broker or other agent, and where the taxpayer sells a part of the stock represented by such certificate through a broker or other agent, an adequate identification is made if:
>
> (a) At the time of the delivery of the certificate to the broker or other agent, the taxpayer specifies to such broker or other agent the particular stock to be sold or transferred; and
>
> (b) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or agent.
>
> Where part of the stock represented by a single certificate is sold or transferred directly by the taxpayer to the purchaser or transferee instead of through a broker or other agent, an adequate identification is made

[4] *See generally* Where can I find the private keys for my wallet?, Coinbase.

[5] *See generally* Why can't I see my transaction in the blockchain?, Coinbase.

[6] One exception to this is when a user cashes coins out of the exchange. In that case, the exchange converts the user's fungible value into particular coins in its inventory, debits the value of these coins in the user's wallet, and transfers these coins to the user along with corresponding private keys. Unlike transactions among its users, transactions cashing-in and cashing-out of a custodial exchange are actually recorded in the blockchain.

[7] The regulation also specifies rules for certain types of mutual funds and bonds.

[8] Reg. §1.1012-1(c)(1), Reg. §1.1012-1(c)(2).

[9] Reg. §1.1012-1(c)(3).


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if the taxpayer maintains a written record of the particular stock that he intended to sell or transfer.

Reg.§1.1012-1(c) codifies the holdings of a series of cases that collectively note the difficulties in computing cost basis for the sale of fungible corporate stock and address how this can and cannot be adequately done in various scenarios.[10]

Despite the similarities between the cost basis issues presented by fungible exchange-based crypto and fungible corporate stock, these two assets differ in several important ways. First, unlike the manner in which proof of corporate ownership is recorded on a stock certificate or lot number, proof of crypto ownership is established by possession of a private key. Additionally, rather than using brokers and agents to buy and sell, crypto holders typically enter into transactions by themselves. These differences are critical because the applicability of the corporate stock safe harbors specified in Reg.§1.1012-1(c) rise and fall on whether there is a stock certificate and who has custody of it as well as whether and what instructions were given to the taxpayer's broker or agent. As such, the literal application of these safe harbors to exchange-based crypto would be nonsensical. Consequently, rather than literally applying these safe harbors, courts are more likely to apply general principles from the cases that led to and interpreted these regulations in navigating the similar cost basis issues presented by fungible crypto.

In a corporate stock pre-safe harbor case called *Halvering v. Rankin*, 295 U.S. 123 (1935), the Supreme Court addressed whether a taxpayer who traded on margin through a brokerage that had never secured, delivered, or allocated to him any stock certificates could adequately identify the cost basis of the corporate stock shares he sold. In that case, ''the purchases and sales affecting his account were made through the medium of street certificates handled by the broker; and the transactions were evidenced solely by debits and credits in his account on the broker's books.'' The IRS argued that, because the shares that the taxpayer traded could not be identified via stock certificate, cost basis could not be adequately identified. Thus, the FIFO method must be used.[11] The Supreme Court disagreed. It held that identification by stock certificate is not the only means. The Court ultimately concluded that ''the required identification is satisfied, if the margin trader has, through his broker, designated the securities to be sold [at or before the sale] as those purchased on a particular date and at a particular price.''[12] In that particular case, the instruction was substantiated through the testimony of an associate of the taxpayer's broker as well as a business associate who had conveyed the taxpayer's instruction to that associate.

In a more recent case, *Concord Instruments Corporation*, T.C. Memo 1994-248, the Tax Court addressed whether the corporate stock safe harbors are the only way for taxpayers to adequately identify the cost basis of corporate stock and, thus, avoid defaulting to FIFO. It held that they are not. To the contrary, the court noted that ''adequate identification can be made in many ways.'' In that case, the court found that the taxpayer's oral standing instruction to his broker to sell the highest cost basis shares was sufficiently adequate to avoid FIFO. Moreover, the veracity of these instructions was corroborated by cost records maintained by the taxpayer, which documented each lot that was purchased, the date it was purchased, and the price per share.

## CONCLUSION

The aforementioned case law concerning corporate stock provides persuasive authority for the position that taxpayers can specifically identify an analogous fungible asset, exchange-based crypto, in a manner courts will deem adequate. By specifically identifying the highest-cost crypto first, he or she may be able to greatly reduce capital gains in early years.

To support such a position, it is imperative that taxpayers maintain a record of the types and amounts of crypto bought on custodial exchanges as well as the particular dates of transactions and prices. Moreover, taxpayers must contemporaneously document their intent to sell particular crypto. While this can be done orally, it is better for taxpayers to provide contemporaneous writings that document both the substance and timing of their designation. This may be accomplished with a memorandum to file that includes metadata, an email with a time and date stamp, or a statement to a bookkeeper or tax preparer that is contemporaneously recorded in their third-party records. After the completion of each transaction, taxpayers should cause their books to be updated to remove from their capital asset ''inventory'' the crypto they designated to be sold.

Although the aforementioned approach appears legally supportable, the law in this developing area is far from settled. Consequently, taxpayers must be cognizant that the IRS and/or the courts may ultimately disagree with this approach. To avoid penalties in this event, taxpayers should consider having their tax preparer include a Form 8275 Disclosure Statement along with their tax return disclosing this position.

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[10] *Kluger Associates, Inc. v. Commissioner*, 617 F.2d 323 (2d Cir. 1980)(exploring the history of Reg. §1.1012-1(c)); *See also Hall v. Commissioner*, 92 T.C. 1027, 1033-34 (1989)(noting ''when a taxpayer has acquired stock on different dates or at different costs and sells only a portion of that stock, a problem arises identifying the cost or basis of the stock sold . . . . Recognizing this problem, [the IRS] has provided by regulations several safe harbor means of complying with the statute requirements.'').

[11] The IRS took this position based on an applicable Treasury regulation in effect (Reg. No. 74, Art. 58) at that time, which provided, ''when shares of stock in a corporation are sold from lots purchased at different dates and at different prices, and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchases of such stock.''

[12] Despite the Court's holding, it was careful to note that, to avoid FIFO, the taxpayer must make the instruction prior to or at the time of the sales at issue.


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