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How To Deduct Expenses Incurred In Trading Securities

The Keys to Unlocking the Mysterious and Elusive "Trader" Status

BACKGROUND

With the advent of the Internet and the unfettered access we now have to national and international financial markets, it's never been easier to trade securities. With nothing more than a computer, Internet access and some kind of trading platform, anyone can be his own securities broker. The average person can buy stocks, mutual funds, bonds, cryptocurrency, and other financial assets, directly from his home or office, anytime of the day or night.

This access spawned an investment phenomenon known as "day trading." Such trading is carried out by a "trader." This is a person who, rather than "investing" in securities for long-term purposes (such as building a retirement nest egg), "trades" securities on a daily basis with the idea of generating current income to pay living expenses. The "trader" buys and sells stocks on a daily basis, trying to capture current income as the stocks fluctuate on a short-term basis.

The difference between an "investor" and a "trader" is significant for federal tax purposes. Most significant is the manner in which the expenses of trading are treated for tax purposes. The thrust of this report is to address, (1) what constitutes a "trader" under federal tax law, (2) the manner in which the income

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and expenses of a "trader" are treated by the Internal Revenue Service (IRS), and (3) I show you how to adopt and maintain "trader" status to defeat any potential challenge by the IRS.

THE LEGAL ISSUE

To understand where we are, we need to know where we came from.

Before 1934, all gains derived from the activity of trading in securities were taxed as ordinary income, not as capital gain income. This was true regardless of whether the gains were derived from long-term or short-term trading. For more on this history, see *King v. Commissioner*, 89 T.C. 455, 457 (1987).

In 1934 the law changed. Per the change, it was determined that profits earned by "traders" were *not* considered ordinary income, but rather, such profits were treated as capital gains or losses. Thus, all profit is capital gains, if one is a "trader." Congress effectuated this change by amending the definition of the term "capital asset." The amendment had an immediate effect, as explained by *King*:

> A dealer falls within an exception to capital asset treatment because he deals in property held primarily for sale to customers in the ordinary course of his trade or business. A trader, on the other hand, does not have customers and is therefore not considered to fall within an exception to capital asset treatment. *King* at 458.

So after 1934, a stock speculator trading on his own account would be entitled to capital gain and loss treatment on his trades, rather than having the gains taxed as ordinary income.

The difference between ordinary income and capital gain income is significant. Ordinary income, such as wages and business profit, is generally taxed at higher rates than capital gain income. The ordinary income tax rates are graduated. There are seven brackets (as of 2023) with the highest being 37%. On the other hand, capital gain is passive income, that which is derived from the sale of assets such as real estate or, in this case, securities (stocks and bonds).

How such income is taxed depends on how long the asset was held. Assets held for one year or less are considered short-term capital gains. They are taxed at the ordinary income tax rates. Assets held for more than one year are considered long-term capital gains. They are taxed at the applicable capital gain rate (which can be lower than the applicable income tax bracket). Thus, a day trader's income is always taxed as short-term capital gains. Also, capital gain income, whether long-term or short-term, is not subject to the Social Security tax.

Next we move to expenses. Expenses incurred by passive "investors," those seeking long-term savings and capital growth for future purposes (not current living expenses), are considered "investment" expenses, not business expenses. As such, they are classified as miscellaneous itemized deductions that would normally be reported on Schedule A (Form 1040) Itemized Deductions.

A "trader," by contrast, is a full-time investor in securities who trades for current income, rather than future investment growth. A "trader" lives off his market gains now. As such, expenses incurred by a "trader" in his active trading business are considered business expenses. They are deductible under Internal Revenue Code § 162 as ordinary and necessary business expenses. They are reported on Schedule C (Form 1040), Profit of Loss from Business. To put it simply, "[T]he proper taxation of gains and losses from a taxpayer's securities activity depends on whether he or she is a dealer, a trader, or an investor." *Assaderaghi v. Commissioner.*, T.C. Memo. 2014-33 at *3.

The difference is significant. A "trader" gets an immediate deduction for all expenses incurred in earning income from the trading business. Such expenses are claimed on Schedule C. Expenses for investors are a different story. As stated, these generally constitute miscellaneous itemized deductions and are claimed on Schedule A, but such expenses are generally deductible only to the extent that they exceed 2 percent of adjusted gross income. Thus, the first 2 percent of expenses incurred by "investors" are and never were deductible.

But it gets worse. Effective with the Tax Cuts and Jobs Act of 2018, miscellaneous expenses in general, including those incurred in investing efforts, are no longer deductible. That law suspended "all miscellaneous itemized deductions that are subject to the two-percent floor under present law." These include investment expenses when the citizen is *not* eligible for "trader" status.

As a result, investment deductions that used to go on Schedule A can no longer be claimed anywhere. "Traders" get to deduct their trading expenses; "investors" do not. Thus, it is even more important now than ever to understand the difference between "investing" and "trading."

WHAT ARE THE CHARACTERISTICS OF A "TRADER"?

The Internal Revenue Code does not define the term "trader," so courts have formulated a set of factors for determining this legal characterization as distinguished from an "investor." For starters, the Tax Court stated that, "In order to qualify as a trader (as opposed to an investor) petitioner's purchases and sales of securities during 1999 must have constituted a trade or business." *Chen v. Commissioner*, T.C. Memo. 2004-132, *3 (2004). So, "traders" run a trade or business. Investors do not.

But in the over-4-million words in the Internal Revenue Code, there is no comprehensive definition of the phrase "trade or business." And yet, dozens of tax code sections use that phrase in the treatment of income and expenses. Again the courts have stepped in, and the Supreme Court in *Higgins v. Commissioner*, 312 U.S. 212 (1941), stated that the question whether the conduct of a given activity constitutes "carrying on a trade or business" is a facts-and-circumstances test to be decided on a case-by-case basis.

The long history of litigation in this area has provided a large body of case law and administrative guidance interpreting the meaning of "trade or business" in the context of code § 162. This guidance tells us that an activity "conducted on a regular, continuous, and substantial basis for the purpose of making a profit constitutes a 'trade or business' for purposes of the Internal Revenue Code." See, e.g., Proposed Treasury Regulation § 1.199A-1(b). See also, my extensive discussion of a "trade or business" in chapter 4 of my book, ***Dan Pilla's Small Business Tax Guide***.

The court in *Estate of Yaeger v. Commissioner*, 889 F.2d 29, 33 (2nd Cir. 1989) elaborated further:

> Traders are those "whose profits are derived from the 'direct management of purchasing and selling.'" Investors derive profit from the interest, dividends, and capital appreciation of securities. They are "primarily interested in the long-term growth potential of their stocks." Traders, however, buy and sell securities "with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a

short term basis." [Internal citations omitted.]

I break down these factors into topical categories below, but keep in mind that the determination of "whether a taxpayer's trading activities rise to the level of carrying on a trade or business turns on the facts and circumstances of each case." *Yaeger* at 33. And, whether a taxpayer is a "trader" or not, is a question of fact. *Assaderaghi*, *supra* at *3.

1. Profit motive. The profit motive test is the key to the equation, as the profit motive factors weigh directly on the question of one's intent to operate a business or not. The question of "profit motive" speaks to one's subjective intent to earn profit from the activity, whether or not he actually does. See my ***Small Business Tax Guide*** for a detailed analysis of this subject. With respect to trader status, a typical statement by courts is this one, from *Paoli v. Commissioner*, T.C. Memo. 1991-351,

> We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. (Emphasis added; internal quotation omitted.)

Specifically, courts look at the *type* of profit the taxpayer sought through his trading activities. "Courts also look at whether the taxpayer's securities income is principally derived from frequent sales of securities, rather than from dividends, interest, or long-term appreciation." *Poppe v. Commissioner*, T.C. Memo. 2015-205 at *5. In other words, to be a "trader," the profit must come from short-term market swings, not from dividends or interest or long-term gains.

Again:

> Thus, in order to qualify as a "trader" who was engaged in the trade or business of stock trading during 1982, petitioners must prove that Mr. Paoli was engaged in purchasing and selling stock regularly, frequently, and in substantial volume, and also that he sought to profit from short-term market swings, rather than from

> long-term appreciation and income. *Paoli*, *id;* emphasis added.

And again: "For a taxpayer to be a trader he must also seek to catch the swings in the daily market movements and profit from those short-term changes." *Assaderaghi* at *5.

Thus we see three threshold criteria necessary to qualify for trader status. You must: (1) have the subjective intent to operate a business and earn profit, (2) be engaged regularly and frequently in trading securities (as opposed to occasionally or sporadically), and (3) you must trade for current income from short-term price changes in the market, not long-term growth. I delve farther into the issue of trading practices next.

2. <u>Trading practices</u>. This factor overlaps with the profit factor because how one trades necessarily affects the profit from the trading activity. As the Tax Court said:

> A taxpayer's trading activities constitute a trade or business within the meaning of § 162(a) where both of the following requirements are satisfied: (1) the taxpayer's trading is substantial, and (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from those short-term changes rather than to profit from the long-term holding of investments. *Assaderaghi* at *4.

Let's examine these factors more deeply.

a. "<u>Substantial" volume of trades</u>. The more trades one makes the more likely one is a trader, not an investor. Therefore, courts want to see a "substantial number" of trades. The technical definition of "substantial" is unfortunately somewhat circular: "For a taxpayer to be a trader the trading activity must be substantial, which means frequent, regular, and continuous enough to constitute a trade or business, as opposed to sporadic trading." *Holsinger v. Commissioner*, T.C. Memo. 2008-191, *3; internal quotation omitted.

But in practice, courts consider the number of trades executed in a year, the amount of money involved in those trades, and the number of days in which trades were executed. For example, the court in *Endicott v. Commissioner*, T.C. Memo. 2013-199 at *4, cited cases where 372 and 313 trades in one year were held not to be substantial, but 1,136 trades was substantial. It held that the 303 trades by petitioner (fewer than one per day) in one tax year was not substantial but 1,543 trades (more than four per day) in another tax year was substantial.

Similarly the court in *Holsinger* said:

> In *Paoli* [*supra*], the Court held trading activities were substantial when the taxpayers traded stocks or options worth approximately $9 million. In *Mayer* [*infra*], the Court considered over 1,100 executed sales and purchases in each of the years at issue therein to be substantial trading activity. Trading activity [in another case] was found to be insubstantial when a taxpayer executed at most 83 purchases and 41 sales in one year and 76 purchases and 30 sales in the second year. *Holsinger* at *3.

b. <u>Regular and frequent; no sporadic lapses</u>. This factor addresses gaps between trades. A "trader's" trading habit must be regular, frequent and continuous enough to indicate that he is working a job, rather than passively investing. Investors might take their eye off their portfolios for months (or even years) at a time, but traders can not. Taking substantial time off during the year suggests an investor's profile, not that of a trader. As the court in *Yaeger*, supra at 33 put it:

> Investors derive profit from the interest, dividends, and capital appreciation of securities. [Citations omitted.] They are "primarily interested in the long-term growth potential of their stocks." *Id*. Traders, however, buy and sell securities "with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis." [Citations omitted.] Thus, the two fundamental criteria that distinguish traders from investors are the length of the holding period and the source of the profit.

Said another way, "For a taxpayer to be considered a trader, the taxpayer's trading activity must be 'substantial,' and it must be 'frequent, regular, and continuous' to be considered part of a trade or business. … <u>Sporadic trading does not constitute a trade or business.</u>" *Chen v. Commissioner*, T.C. Memo. 2004-132 at *3 (emphasis added).

But what is "sporadic trading"? It is the practice of going weeks or months without a trade. As the Tax Court said:

> The record demonstrates that petitioner usually maintained his option positions for a period between one and five months. Maintaining option positions for a period of between one and five months is not indicative of seeking to catch and profit from the swings in the daily market. *Endicott*, *supra* at *7.

For example, in *Assaderaghi*, the taxpayer executed trades on 154 days in one tax year, and on 94 days in another tax year. The court cited a prior decision stating that trading on 110 days a year was not frequent enough, and with that precedent it held that Assaderaghi did not trade frequently enough. The court then came at the same facts from another direction. It noted that the *Paoli* court held that the taxpayers did not trade frequently enough because 40 percent of their yearly sales were made in a single month. Similarly, Mr. Assaderaghi traded on fewer than ten days in the months of February, August, and October of the first year, and fewer than ten days in each of January through June in the following year, including zero trades in February 2009. The court held, based on the *Paoli* precedence, that his trades were not frequent enough. See also *Chen*, *supra* (trading activity is not frequent enough when 94 percent of the trades occurred in three months of the year, and no trades occurred in six months of the year); *Nelson v. Commissioner*, T.C. Memo.2013–259 (holding that executing 95 out of 535 trades during a one-week period and not making any trades during eight separate seven-day periods was not regular and continuous).

Commissioner, T.C. Memo. 1994-209, this factor was one of two "fundamental criteria that distinguish traders from investors" (the other being the source of profit — was it from short-term price swings or was it from long-term dividends or capital growth). "Thus, whether or not Mr. Mayer was in the business of trading depends on whether he sought to capitalize on short-term swings in the market, or instead strove for long-term appreciation of his capital." *Mayer* at *5. The *Assaderaghi* Court stated:

> To determine whether a taxpayer seeks to catch the swings in the daily market the Court reviews the holding period of the securities. [Citations omitted.] In *Holsinger*, we held that the taxpayer did not seek to catch the swings in the daily market because a significant amount of his stock was held for more than 31 days. Similarly, in *Kay*, we held that the taxpayer was not a trader because most of his stocks were held for over 30 days. *Assaderaghi*, *supra* at *5.

This is another way of saying that "traders" derive profit from short-term market swings, but "investors" play the long game:

3. <u>Daily trading</u>. This factor builds on the "frequency" factor. You must invest time in your trading activity on a daily or almost-daily basis, not just a few hours per week or month. This factor is crucial, because "[i]n cases in which taxpayers have been found to have been traders, the number of a taxpayer's transactions evidenced that the taxpayer was engaged in market transactions <u>on an almost daily basis</u>." *Nelson v. Commissioner*, T.C. Memo. 2013-259, *6 (emphasis added); *Endicott* at *5 (same).

And see *Chen* at *4, where the Tax Court stated:

> In the cases in which taxpayers have been held to be traders in securities, the number and frequency of transactions indicated that they were engaged in market transactions <u>almost daily for a substantial and continuous period</u>, generally exceeding a single taxable year; and those activities constituted the taxpayers' sole or primary income-producing activity. … Daily trading in securities for only a quarter of a single taxable year is reasonably characterized as "sporadic" rather than "frequent, regular, and continuous," and, therefore, insufficient to achieve trader status. (emphasis added)

4. <u>Time on the clock is not dispositive</u>. It would seem right to say that the more time one spends in the activity the more likely one has a short-term profit motive. For example, the court in *Poppe v. Commissioner*, T.C. Memo. 2015-205 (held: taxpayer was securities "trader") considered Mr. Poppe's time on the clock to be a factor suggesting that he was a trader:

> Petitioner testified that he devoted a significant amount of time to the trading activities during the school year—four to five hours every trading day—and always traded on the last hour of the day, when there is a lot of activity on the market. During the summer, petitioner spent 10 to 12 hours a day on his trading activities. *Poppe* at *5.

And in *Paoli*, *supra*, the court would have viewed favorably the testimony that petitioner put in 4-5 hours every day into his trades for a three-month period, if only he made more than one trade during that same three months.

However, time on the clock is not actually a dispositive factor that courts specifically look for. A part time commitment is not fatal to a finding that one is a "trader," and long hours does not necessarily mean one is a trader. The fact of long and dedicated work hours can be nullified by the factors discussed above, as the court said in *Mayer*, *supra*:

> Although Mr. Mayer handled his securities investments in a businesslike manner, that fact is irrelevant to our determination of whether he was a trader or a mere investor. … We reiterate that even "full-time market activity in managing and preserving one's own estate is not embraced within the phrase 'carrying on a business.'" *Mayer* at *6.

Mr. Mayer worked full-time, and even had employees under him, to invest his money. In spite of that, the court held that he was an investor, not a trader, because he held his investments long-term:

> For the years in issue, the weighted average holding periods for securities sold in Mr. Mayer's managed accounts were 317 days in 1986, 439 days in 1987, and 415 days in 1988. For each of the years in issue, the percentage of stocks sold with holding periods of 30 days or less ranged from .01 percent to 5.41 percent. *Mayer* at *5.

FULL TIME OR PART TIME ACTIVITY?

Given the Tax Court's discussion about the number of trades, along with trading consistency and regularity, we must ask whether part-time (as opposed to full-time) trading activity in itself negates "trader" status. As stated above, a mere part-time commitment – by itself – is not fatal to trader status.

It is not wrong to say that one is a "trader" simply because he is attempting to supplement his main income by working part-time in trading activities. For example, suppose you earn $5,000 per month at a wage job. You trade daily on a portfolio that generates $1,000 per month of income. You need (and use) the $1,000 to pay current bills.

In this case, you are in fact a "trader," despite not earning all, or even primarily all, of your income from your trading activities. I say that because in all of the court decisions analyzed for this report, the courts say that the legal test focuses on one's subjective *intent* to earn a profit, along with the question of whether that profit is generated through short-term or long-term trades.

The conclusion is that it is irrelevant whether the trading profit is your primary income source, or whether it constitutes the bulk of your income, or not. The various factors outlined above are what control.

HOW TO PROVE TRADER STATUS

Keep in mind that tax code § 6001 imposes on citizens the duty to "make and keep" records sufficient to substantiate their income and any amounts claimed as deductions for each tax year. Courts ubiquitously interpret that to mean, "Deductions are a matter of legislative grace, and the taxpayer has the burden of showing entitlement to any deduction claimed." *Holsinger*, *supra* at *4. That same burden of proof is put forth in Tax Court Rule 142(a). All of this is to say that one must be prepared to prove his "trader" status in the event of an audit.

At a minimum, the records necessary to meet one's burden of proof include:

- Trading records (showing the number of trades, and their dates),
- Securities account and bank account records (showing the dollar amounts of the buys and sells, any margins or lines of credit, the year-start and year-end balances),
- Other income sources and amounts (e.g., W-2 and 1099), and
- An appointment book, time log, day planner, cal-

endar, phone records, or other proof of time spent in trading activities.

Your own statement, presented in the form of a detailed affidavit, is very important to establish “trader” status. Your statement, signed under penalty of perjury or notarized, must explain:

- Your trading patterns and practices,
- Your trading philosophy such as to allow an uninformed third party to understand how you approach the challenge of making money,
- The fact that you are trading to earn current income either as a primary source of income or to supplement other income, such as wage income, and
- A clear and definitive statement of your intent to earn current income through your trading activity (as distinguished from long-term investments).

An uncontradicted affidavit regarding your intent with respect to your business activities is a very important part of prevailing in an audit. For more details on what constitutes an affidavit and how to create one, see chapter 3 of my book, ***The IRS Problem Solver***.

REPORTING GAINS OR LOSSES FROM TRADING ACTIVITY

The gains realized from your trading activity are classified as capital gains. This is true regardless of the fact that the overwhelming majority (if not all) of your gains will be short-term. Capital gains and losses are reported on Schedule D (Form 1040), Capital Gains and Losses, and on Form 8949, Sales and Other Dispositions of Capital Assets.

Because the gains and losses from trading are capital in nature, the limitation on deducting capital losses applies. This means that the amount of capital loss that may be written off against other income is limited to $3,000 per year. On the other hand, 100 percent of the capital gain is taxed as income in the year it is realized. Let me illustrate:

Suppose you have $50,000 in wage income and earned $10,000 trading on your portfolio. The wage income is ordinary income and is subject to Social Security taxes. The trading income is capital gain and is not subject to Social Security taxes. The full $10,000 of trading income is reported on your tax return and is subject to income taxes as a short-term capital gain.

Now suppose you have $50,000 in wage income and a loss of $5,000 trading on your portfolio. Capital losses are subject to an annual deduction limit of $3,000. Thus, the loss reduces your income to $47,000. The unused portion of the loss ($2,000) is carried forward indefinitely until it’s either used up in future years or offset by other capital gains.

This is another reason it is so important to keep careful and accurate records of your trading activities, as discussed above.

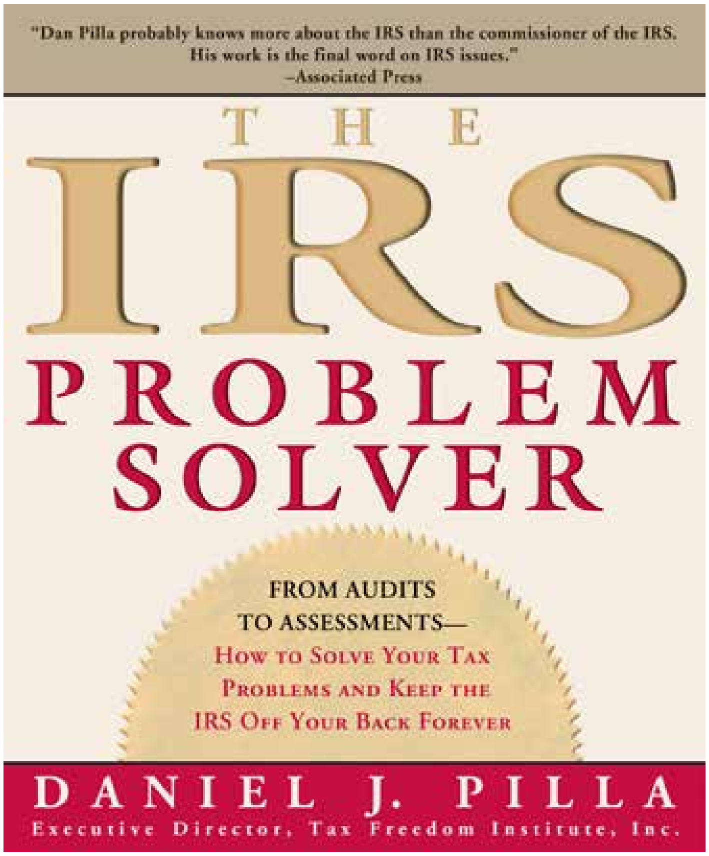
DEDUCTIBLE TRADING EXPENSES

When you qualify as a “trader,” your trading expenses are tax deductible business expenses. This is the key to “trader” status, because the expenses of “investors” are simply not deductible. A deductible business expense generally includes any expenditure necessary to the success of the business (that is, to earn income), as long as the expense is reasonable under the circumstances.

Expenses more directly associated with trading activities include (but are not necessarily limited to):

- Home office expenses for space used regularly and exclusively for the business of trading,
- Costs for research and educational materials,
- Expenses for tools, equipment and supplies,
- Computer hardware and software,
- Costs for Internet access and fees incurred to access trading platforms,
- Fees and commissions paid to third parties *,
- Postage and shipping costs,
- Legal and professional fees directly related to the business,
- Travel, lodging, meals, and registration expenses for meetings and conventions that have a primary business purpose, and
- Consulting fees paid to counselors, advisors or technicians.

> * NOTE: Commissions and other costs specifically related to acquiring or disposing of securities aren’t deductible as expenses. They must be used to figure gain or loss upon the disposition of the securities. Thus, a commission paid to



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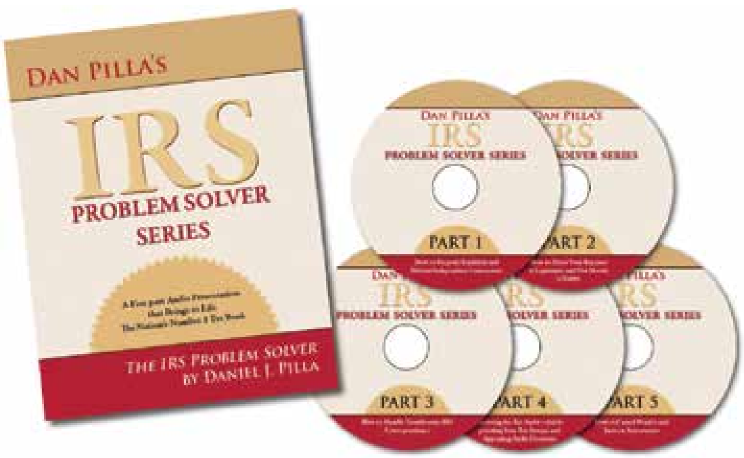

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acquire a specific security is added to basis. The commission increases the cost of the security, which is deducted from gross sales proceeds to determine profit or loss.

As explained above, it is your responsibility to make and keep records that accurately reflect the nature and amount of the expense, as well as to prove that the expense was directly related to your trading business. Expenses of the trading business are claimed on Schedule C. The expenses offset the capital gain income that's reported on Schedule D. You are taxed on the net profit.

CONCLUSION

In summary, your trading activities will qualify you for "trader" status if:

1. It is apparent from how long you hold your positions that you seek to earn profit from short-term market fluctuations to produce current income to live on, rather than from the long-term growth of your investments;
2. The number and frequency of your transactions is "substantial;"
3. There are no material gaps in your trading timeline, but rather it is "regular and continuous;" and
4. You trade almost daily.

GET PROFESSIONAL HELP

This is a complicated and highly technical area of the law. If you have the slightest bit of doubt where you stand with your trading activities, get qualified help before you run into audit problems. Mistakes in this area can be very costly. To get help contact the Taxpayers Defense Institute member nearest you. For more information, click or call:

www.taxhelponline.com
www.pillataxacademy.com
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Civil and Criminal Pitfalls of Cryptocurrency

The Dark Side of Cryptocurrency

BY NATHAN MACPHERSON, J.D.

OVERVIEW

The use of cryptocurrency is at an all-time high, having skyrocketed from an estimated five million monthly users in 2016 to over 400 million at the end of 2022.[1] Indeed, the International Monetary Fund is even working with central banks around the world to explore so-called "Central Bank Digital Currencies" (CBDCs).[2] It is fair to say that the use of cryptocurrency has become mainstream. However, despite the asset itself now being ubiquitous, knowledge of the civil and criminal pitfalls related thereto are about as obscure now as Bitcoin was when it was first launched on January 3, 2009.

That cryptocurrency is on the IRS's radar was obvious starting with the 2020 Form 1040, on which IRS began asking, "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?" Beginning with the 2022 Form 1040, the IRS updated the question to ask, "At any time during 2022, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)" For more on this, see the article, "Disclosing Digital Asset Transactions," in the February 2023 issue of *PTT*.

Additionally, under the *2021 Infrastructure Investment and Jobs Act*, cryptocurrency exchanges are

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required to issue Forms 1099-B, enumerating their clients' cryptocurrency transactions,[3] and on September 22, 2022, a U.S. District Court judge entered an order authorizing IRS to issue a "John Doe summons" requiring a bank to produce records regarding U.S. taxpayers who may have failed to report and pay taxes on their cryptocurrency transactions.[4] So much for cryptocurrency secrecy.

However, this was not the beginning of federal cryptocurrency scrutiny. Already in March of 2014 — a mere five years after the launch of Bitcoin — a New York man was indicted for operating a Bitcoin exchange service from December 2011 to October 2013.[5] He later plead guilty to operating an unlicensed money transmittal business and was sentenced to four years in federal prison.[6] The seminal issue in his case was whether cryptocurrency is "money" within the meaning of *Title 18*. (It most certainly is.)

Since then, there have been scores of prosecutions — of everyday people — trading cryptocurrency. As recently as March 2023, a grand jury in Cleveland, Ohio, indicted a business owner, his father, and their attorney "on several charges including Engaging in a Pattern of Corrupt Activity, Conspiracy, and License Requirement Violation for owning and operating cryptocurrency kiosks in Northeast Ohio from [January 2019] to February 2023."[7] According to the news release by the Cuyahoga County Prosecutor, "The investigation was conducted by the United States Secret Service (USSS) Cyber Fraud and Money Laundering Task Force with assistance from" no fewer than 28 local, state, and federal law enforcement agencies (including, of course, the Ohio Department of Taxation, Criminal Investigations Division) across at least four different states. Even Biden's Secret Service is going after cryptocurrency sellers!

It is clear from all of this that cryptocurrency transactions can easily entangle taxpayers in a morass of civil and criminal laws and regulations, and that the IRS and state revenue departments are driving the process. In fact, the IRS's SB/SE Examination Division Commissioner De Lon Harris made it clear: cryptocurrency tax compliance is "one of [the Division's] top enforcement priorities."[8]

In order to properly advise their clients, tax practitioners need to be aware of the myriad issues. *Forewarned is forearmed.*

CRIMINAL LAW ISSUES

FinCen Registration. First, a distinction must be made between someone who simply acquires cryptocurrency as an investment and someone who sells it to others. Federal law requires all persons who control a "money transmitting business" to register the business with the Secretary of the Treasury. This registration requirement is independent of whether such business is licensed as a "money transmitting business" in any state.[9] Failure to register with FinCen (or under state law when required) is a crime[10] (independent of any potential money laundering offenses).

The factual distinction is whether a person is acquiring the cryptocurrency to hold as an investment and later sells some or part of his investment — as with a stock portfolio — or, perhaps, uses the investment to purchase something else (as with cash in a bank account used to purchase a product), as opposed to someone who acquires the cryptocurrency as inventory for resale. Clear evidence of the latter is that of a person advertising to sell cryptocurrency on a marketplace such as Local Bitcoins dot com. Ultimately, this is a question of fact. The court decisions do not address this issue; the matter is uncontested in the reported cases because those being prosecuted are not merely trading for their own account but are, in fact, engaged in "transmitting."

Under *18 U.S.C. § 1960(a)*, anyone who knowingly conducts, controls, manages, supervises, directs, or owns all or part of an "unlicensed money transmitting business" faces a fine and five years in prison. The term "knowingly" simply means you knew you were engaged in exchanging cryptocurrency, not that you knew you had to be licensed and were not. The verbs include any active involvement or ownership. The definition of "unlicensed money transmitting business" is given in subsection (b)(1) of the statute. Under the law, a "money transmitting business" is one which affects interstate or foreign commerce (thus the federal jurisdiction) and meets one (or more) of these three further elements:

(A) The business is not licensed in the state of operation and such failure to license in that state is itself a misdemeanor or felony under state law (thus, if state law requires you to register, you must also register with the feds);
(B) The business is not registered under *31 U.S.C. § 5330* (failure to register under federal law is a crime); or
(C) The cryptocurrency transactions involve funds the defendant knows are related to unlawful activities. (Here, the "knowingly" element is as to the source or use of the funds — that they are proceeds of crime or used to support crime.)

Remember, the courts have consistently held: (a) that cryptocurrency is "money" or "currency" or "funds" under the law, and a "money transmitting business" is one in which one currency is exchanged for another (i.e., dollars for Bitcoin, Bitcoin for Etherium, Dogecoin for Euro, etc.), and, (b) to meet the "knowingly" requirement one must simply know that one is exchanging one currency for the other. Note also that you can be subject to prosecution under both federal and state law. Most states require registration, while a few others are havens for cryptocurrency exchanges.[11]

Why such an interest in, and registration requirement for, people exchanging cryptocurrency for cash? The answer: money laundering! Cryptocurrency is used by organized crime to launder money, and the criminals often do so by using unsuspecting "money transmitters." Part and parcel to FinCen registration are FinCen's anti-money-laundering and know-your-customer (AML/KYC) rules.

In one recent case, I represented a client who was told by another trader he was not required to register with FinCen and learned from the trader how to post ads online. He then sold Bitcoin ranging in amounts from $50 to around $5,000, with most sales ranging from $100 to $1,000 in value. Seems innocent enough, right?

Imagine my client's surprise when he was sitting across from an Assistant U.S. Attorney and an IRS Criminal Investigation (CI) special agent and was not only reminded of all of his cryptocurrency transactions (somehow the government knew more about his trades than my client did!) but was also informed that the people to whom my client transmitted Bitcoin were not the innocent people he thought they were. Rather, they were actually part of a nationwide organized crime ring.

My client soon learned that a "smurf" is not just a blue cartoon character. It also a person who obtains stolen or illicit funds, or deposits them into an unsuspecting bank account for laundering. The "smurf" generally has contact with the victim or his financial account. My client also learned that a "mule" is not just the sterile offspring of a male donkey and a female horse. It is also a person who, knowingly or unsuspectingly, transfers the stolen or illicit funds. This can be an unsuspecting "money transmitter," in this case, my client.[12] This was an expensive lesson that he learned the hard way during settlement discussions while facing charges of bank fraud, wire fraud, conspiracy, money laundering, failure to file and tax evasion — and of course — failure to register with FinCen and with his state of residency.

Tax evasion. This brings us back to the IRS. The first contact my client had with federal agents was a visit by IRS CI. The first line of scrutiny was my client's Form 1040, and in particular his Schedule D, or more particularly, the *lack* thereof. The IRS was aware of his cryptocurrency transactions (somehow those aren't as secret as people think) and noticed his failure to report them. One thing led to another, as the saying goes. When we first held our initial consultation and evaluation, the client thought it was just a "simple" IRS issue; the more he described his situation, the more I realized that he was facing much more than tax crimes.[13]

CIVIL TAX ISSUES

While your average tax client probably does not engage in cryptocurrency transmitting, he probably does have some cryptocurrency holdings, including several purchases and sales annually. Moreover, he probably also does not realize he needs to keep records and report the transactions on his return. As to the common mistakes made in these areas, see the article in the February 2022 issue of *PTT*, mentioned above.

While the new 1099-B reporting requirement could make things easier, the return preparer will still be tasked with properly reporting capital gains and losses of cryptocurrency transactions. This task can be even more difficult when one cryptocurrency is sold, not for cash, but for another cryptocurrency, or is traded for other goods or services.

Moreover, I have seen improperly issued Forms 1099-B that report *purchases* of cryptocurrency as if they were *sales*. It was only because I was able to show bank records and exchange records showing dollars leaving my client's bank account and being deposited into the exchange, and purchases of cryptocurrency via the exchange, that the IRS agreed that their proposed assessment was invalid. For more on how to handle erroneous information returns, see Dan's book, ***How to Win Your Tax Audit***.

The IRS has computer programs that analyze exchange data files (in *.csv format) and match purchases, sales, and exchanges to determine gains and losses. Remember that a 1099-B is *prima facie* evidence of the gains reported thereon, and the burden lies with the taxpayer to overcome the presumption of accuracy. Note, however, that this burden can be shifted following the procedures discussed in Dan's book. Nevertheless, your clients need to be prepared to provide substantiation of all purchases and sales, of all gains and losses thereon — and you need to educate them to that end.

SUMMARY AND CONCLUSION

About one in five U.S. adults holds cryptocurrency[14] and cryptocurrencies are a top target of the current IRS administration.[15] The IRS's CI Chief Jim Lee announced last month that IRS is even opening a new cyber crimes data unit to target complex cryptocurrency crimes.[16] Cryptocurrency transactions can lead to serious civil and criminal issues, criminal investigations for failure to file and tax evasion, which can lead to FinCen and related white collar criminal charges, as well as civil assessments for unpaid taxes, interest and penalties.

Under the *2021 Infrastructure Investment and Jobs Act*, cryptocurrency exchanges are required to issue Forms 1099-B. This is likely to lead to more civil examinations, and more reporting problems due to possible errors on Forms 1099-B, as well as more criminal investigations and possible indictments. Tax practitioners need to be aware of the myriad cryptocurrency issues so they can best advise their clients.

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2 https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/04/12/IMF-Approach-to-Central-Bank-Digital-Currency-Capacity-Development-532177
3 https://www.congress.gov/bill/117th-congress/house-bill/3684
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5 https://www.justice.gov/usao-sdny/pr/bitcoin-exchangers-plead-guilty-manhattan-federal-court-connection-sale-approximately-1
6 https://www.justice.gov/usao-sdny/pr/bitcoin-exchanger-sentenced-manhattan-federal-court-four-years-prison-selling-nearly-1
7 http://prosecutor.cuyahogacounty.us/en-US/BOA-and-3-people-insicted-cryptocurrency-kiosks.aspx
8 https://www.irs.gov/about-irs/providing-resources-to-help-cannabis-business-owners-successfully-navigate-unique-tax-responsibilities
9 31 U.S.C. §5330.
10 18 U.S.C. §1960(a).
11 See, e.g., https://coinatmradar.com/blog/the-fifty-u-s-states-and-cryptocurrency-regulations/.
12 https://www.acamstoday.org/from-smurfs-to-mules-21st-century-money-laundering/.
13 Fortunately, I obtained for my client a "diversion agreement" under which he would not be prosecuted — no charges even filed and no criminal record whatsoever — as long as he paid restitution and stayed completely clean for one year.
14 https://www.bankrate.com/investing/cryptocurrency-statistics/
15 https://www.irs.gov/pub/irs-pdf/p3744.pdf
16 https://www.law360.com/tax-authority/articles/1597808/irs-criminal-unit-to-open-cyber-data-center-chief-says

Modern Monetary Theory

Rest in Peace

BY DR. MERRILL MATTHEWS

Progressives have promoted what's known as Modern Monetary Theory (MMT). Regardless of whether President Joe Biden knows or understands MMT, he has embraced it and imposed it on the U.S. economy. We are all living and struggling with the results.

For a definition and explanation of MMT, we'll use Investopedia.

> *The central idea of modern monetary theory is that governments with a fiat currency system under their control can and should print (or create with a few keystrokes in today's digital age) as much money as they need to spend because they cannot go broke or be insolvent unless a political decision to do so is taken.*

Ah, but classical economic theory says that flooding the economy with fiat money would lead to inflation, and potentially rampant inflation.

The article continues:

> *While supporters of modern monetary theory acknowledge that inflation is theoretically a possible outcome from such spending, they say it is highly unlikely and can be fought with policy decisions in the future if required.*

MMTers got the big spenders they wanted. The Committee for a Responsible Federal Budget reported last September the Biden administration has approved $4.8 trillion in new borrowing. And that was before Congress passed the $1.7 trillion spending package in December.

If MMTers wanted a demonstration project to prove their theory, Biden, Democrats and even a few Republicans were willing to oblige.

So, how's that working out?

Turns out inflation is more than theoretically possible and not so "highly unlikely" as MMT proponents thought. It also turns out that fighting inflation with future policy decisions hasn't been as easy as MMTers would have us believe.

Indeed, as the Federal Reserve Bank aggressively raised interest rates to fight that inflation that wasn't supposed to happen, banks have been caught in the squeeze, holding long-term, low-interest assets they can't shed without big losses. Hence, the current banking turmoil.

But hasn't inflation been moderating? It appears so, but very slowly. And that moderation may be mostly, or perhaps entirely, a result of the money supply declining—which MMTers oppose—since February of last year.

It remains to be seen what will happen now that the Fed and the FDIC have decided to make billions of dollars available in an effort to quell a run on the banks and other bank failures.

Will the government have to borrow or create even more money? Will those steps exacerbate inflation again? No one knows.

But one thing we do know: Modern Monetary Theory is dead. May it rest in peace (or in hell).

Dr. Merrill Matthews *is a resident scholar with the Institute for Policy Innovation and frequent guest host for the Point of View radio talk show, on which he and Dan talk often.*

How You Can Ask Dan Pilla a Question

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