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BLOG

FTX Bankruptcy Tax Series: For FTX Customers Seeking Tax Losses, Details Matter

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On November 11, 2022, FTX filed for Chapter 11 bankruptcy protection along with over 102 other FTX-affiliated entities. The company operated as a digital asset exchange, with several subsidiaries and affiliates, which included Alameda Research, a related cryptocurrency hedge fund. The bankruptcy of the entire operational enterprise and digital asset hedge fund has been a seismic event in the digital asset community, affecting over one million customers and eliciting attention from numerous governmental and banking organizations, including the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), which recently issued a joint statement calling attention to certain potential risks associated with digital assets and digital asset sector participants.[1] Notably, the SEC and CFTC are also investigating FTX and analyzing acceptable regulatory framework for the industry.

Moreover, the aftershocks of the recent developments are only now expected to reach the tax world as over one million account holders collectively begin to evaluate how to report their losses for tax purposes. These 1+ million account holders, including U.S.-based retail customers holding digital assets through the bankrupt FTX entity, now find themselves unable to access their accounts, and the exact amounts that account holders may ultimately recoup are not certain in this relatively uncertain environment. Account holders who have lost assets may ultimately receive some relief in the form of losses afforded under U.S. tax law, though the character and treatment of those losses are far from certain.

This blog is part one of a series of client alerts discussing key tax-related considerations stemming from or related to the FTX bankruptcy. The series is primarily intended to discuss several key principles and considerations that affect account holders' ability to find tax loss relief in light of the current FTX realities.

Application of Worthless Security Rules to Deductions

Unfortunately for customers who find themselves unable to withdraw assets from their accounts, a simple loss deduction of the entire amount may not be immediately available. The general rules under Section[2] 165(g) of the Internal Revenue Code provide for a deduction for *worthless securities* that may be claimed in the tax year in which the securities are deemed to have become worthless. Code Section 165(g) also provides that if any "security" that is a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from the sale or exchange of a capital asset.

There is specific statutory authority regarding the treatment of worthless securities; however, whether cryptocurrency assets may be considered a “worthless security” for purposes of Code Section 165(g) is an area of open discussion. Under Code Section 165(g)(2), a “security” is defined broadly to mean stock, rights to subscribe for or receive stock, bonds, debentures, notes, or certificates, or other evidence of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. Notably, with regards to the requirement of a security, the class action lawsuit filed in the U.S. District Court for the Southern District of Florida against members of FTX management and other promoters asserts that the yield-bearing accounts offered to customers were unregistered securities. On the other hand, however, the Commodity Futures Trading Commission and at least one federal district court has designated at least some cryptocurrency assets as commodities, which may be persuasive for tax purposes. As a result, if cryptocurrency assets are not considered securities for purposes of Code Section 165(g), account holders may find themselves unable to avail themselves of the benefits under Code Section 165(g).

Furthermore, the application of Code Section 165(g) is premised on the ultimate worthlessness of the assets meeting the requirements of the worthless security. To that end, some might suggest that the extent to which the assets held by FTX are truly worthless is uncertain, as the amounts that account holders are able to recoup, if any, have yet to be determined by the bankruptcy court. Accordingly, the ability to claim a loss of worthless securities under Code Section 165(g) may be premature.

Claiming a Loss Deduction Under the Avenue of Investment Theft Losses

Alternatively, FTX’s account holders can review the merits of claiming deductions as investment theft losses under Code Section 165(e) on the theory that cryptocurrency deposits had been stolen by FTX, members of the management team, or others involved with the company. As a general rule, Code Section 165 allows taxpayers to deduct a loss from a theft provided that the taxpayer can establish: (1) the occurrence of a theft; (2) the quantifiable loss; and (3) the date that the taxpayer discovered the theft.

Under the general rules applicable to claims of losses under Code Section 165(e), however, similar complexities arise because a taxpayer must establish that no claim for reimbursement of any portion of the loss exists with respect to which there is a reasonable prospect of recovery. So, filing a proof of claim in the bankruptcy cases involving FTX and its affiliates may impact the 165(e) claim. Moreover, the 165(e) claim does not mature until the taxable year during which it is determined that the account holder will not receive even a partial distribution on its bankruptcy claim.

Summary

While details of the FTX bankruptcy continue to emerge, impacted taxpayers should consider how newly revealed facts affect their filing position in the coming tax season. For further information, please contact any of the authors listed here or your Winston relationship attorney.

In our second client alert in our FTX client alert series, we will discuss observations from simplified reporting procedures that the IRS and Treasury have instituted in previous instances of largescale losses that occurred, for example, after the discovery of the Bernie Madoff investment scandal. The Bernie Madoff Ponzi scheme uncovered in late 2008 resulted in IRS guidance facilitating the recovery of substantial investor losses, the content of which may be instructive to potential guidance that may be issued following the FTX bankruptcy.

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[1] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230103a.htm

[2] All references to Section are to the Internal Revenue Code unless otherwise stated.

4 Min Read

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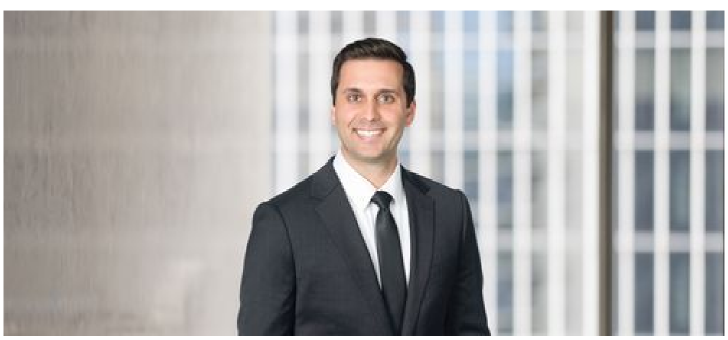

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