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Crypto in Bankruptcy: Tax Apocalypse for Celsius Customers?

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After a series of bankruptcy filings by major cryptocurrency companies, a recent ruling in an ownership dispute in the bankruptcy case of Celsius Network LLC has placed certain interest-bearing account holders in a difficult position. The ruling brings industry-wide repercussions and involves tax consequences that require careful analysis.

CELSIUS BANKRUPTCY AND RECENT RULING

Celsius Network LLC has functioned as a centralized cryptocurrency lending and staking platform since its inception in 2017. Among its services, Celsius allowed customers to deposit cryptocurrencies into custodial Celsius wallets to earn weekly interest payments through its “Earn” program. In June 2022, customers who had made such deposits lost access to their funds when Celsius froze withdrawals due to

“extreme market conditions.”¹ One month later, Celsius and its related entities filed for bankruptcy, raising an important question: *Did the cryptocurrency held by customers in Celsius “Earn” accounts belong to the customers or to the Celsius bankruptcy estate?* If the cryptocurrency belonged to the customers, the assets would be returned and the customers would avoid being swept into the bankruptcy proceedings. If the units belonged to the Celsius bankruptcy estate, however, the customers would become unsecured creditors in the bankruptcy proceedings with their claims subject to the interests of numerous other creditors.

On January 4, 2023, Chief Judge Martin Glenn ruled² in favor of the bankruptcy estate, holding that the crypto units held in Earn accounts were the property of Celsius when the bankruptcy was initiated and therefore became part of the bankruptcy estate. The decision gives the Celsius estate ownership of the \$4.2 billion in cryptocurrency that users deposited under the Earn program and Earn account customers now become unsecured creditors, meaning they will share in any payout from Celsius’s assets with other similarly situated unsecured creditors. This likely means that Earn account holders will not recover their deposits in full.

The court’s ruling has a significant economic impact³ and will likely be appealed, but it appears defensible, because it rests primarily on a close reading of the “Terms of Use” agreement governing the Earn accounts. Those terms provide, in relevant part:⁴

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¹ A *Memo to the Celsius Community*, Celsius Network (June 12, 2022), <https://celsiusnetwork.medium.com/a-memo-to-the-celsius-community-59532a06ecc6>.

² *In re Celsius Network LLC*, Case No. 22-10964, 2023 BL 1162 (Bankr. S.D.N.Y. Jan. 4, 2023), *Memorandum Opinion and Order Regarding Ownership of Earn Account Assets* (hereinafter “Memorandum Opinion”).

³ According to the bankruptcy court’s ruling, Celsius had approximately 600,000 accounts in its high-interest Earn program, and the accounts held a collective value of approximately \$4.2 billion as of July 10, 2022. See *Memorandum Opinion*, 2023 BL 1162, at 5.

⁴ The bankruptcy court recognized the “Terms of Use,” effec-

In consideration for the Rewards payable to you on the Eligible Digital Assets using the Earn Service, for us entering into any Loan Agreement, and the use of our Services, you grant Celsius, . . . all right and title to such Eligible Digital Assets, including ownership rights, and the right, without further notice to you, to hold such Digital Assets in Celsius' own Virtual Wallet or elsewhere, and to pledge, repledge, hypothecate, rehypothecate, sell, lend, or otherwise transfer or use any amount of such Digital Assets, . . . with all attendant rights of ownership, and for any period of time, and without retaining in Celsius' possession and/or control a like amount of Digital Assets or any other monies or assets, and to use or invest such Digital Assets in Celsius' full discretion. You acknowledge that with respect to Digital Assets used by Celsius pursuant to this paragraph:

1. You will not be able to exercise rights of ownership;
2. Celsius may receive compensation in connection with lending or otherwise using Digital Assets in its business to which you have no claim or entitlement; and
3. In the event that Celsius becomes bankrupt, enters liquidation or is otherwise unable to repay its obligations, any Eligible Digital Assets used in the Earn Service or as collateral under the Borrow Service may not be recoverable, and you may not have any legal remedies or rights in connection with Celsius' obligations to you other than your rights as a creditor of Celsius under any applicable laws.

In short, subject to any reserved defenses, all Earn account holders agreed that any cryptocurrency they deposited into an Earn account became the property of Celsius and, further, that in the event of Celsius's bankruptcy, such crypto might not be recoverable other than as a creditor of Celsius.⁵ Assuming the ruling withstands appellate review, Earn account holders should begin planning to limit their losses. This includes considering the potential tax implications.

TAX CONSEQUENCES AND OPPORTUNITIES

At the outset, it is important to note that the precise tax treatment of Earn account holders' losses is un-

ative April 15, 2022, as the controlling document for its memorandum opinion. *See* Memorandum Opinion, 2023 BL 1162, at 5.

⁵ In reaching his conclusion, the judge also reviewed records from Celsius indicating that 99% of Earn account holders had digitally accepted the most updated versions of the Terms of Use agreement. *See* Memorandum Opinion, 2023 BL 1162, at 6.

clear, because the IRS has not issued guidance regarding the tax issues raised by the Celsius bankruptcy — this is still a largely unsettled area of law. It is also important to recognize that the IRS could issue special guidance to address issues caused by bankruptcies in the cryptocurrency industry (e.g., FTX, Voyager, BlockFi, Celsius, etc.), like the guidance the IRS issued in 2009 in the aftermath of the Madoff Ponzi Scheme.⁶ Celsius customers facing unsettled legal issues should consult a tax professional for guidance and updates on any special IRS relief.

Is an Earn Account Deposit a Taxable Event?

The Celsius Earn program allowed account holders to deposit cryptocurrencies like Bitcoin, Ethereum, and Tether into a custodial Celsius wallet in exchange for weekly interest payments. Depending on the time horizon and the cryptocurrency deposited, the platform offered as much as 18% interest annually.

The IRS has not issued formal guidance on the tax treatment of lending arrangements like Celsius Earn, but general tax principles suggest that opening an Earn account would be non-taxable, given that a deposit of units into an Earn account is not clearly a sale or disposition of those units for tax purposes.⁷ The precise terms of the Earn program are important, however.

Under the Internal Revenue Code (“Code”),⁸ a taxpayer generally does not recognize gain or loss until the taxpayer sells or otherwise disposes of an asset.⁹ With respect to the Celsius Earn program, the bankruptcy court concluded that Earn account holders affected a taxable disposition when depositing their cryptocurrency into an Earn account because the Earn program's Terms of Use¹⁰ required a complete transfer of ownership from customers to Celsius. In effect, customers “sold” their crypto for Celsius debt at the time of deposit in a taxable exchange.

⁶ *See* Rev. Rul. 2009-9 (providing guidance on determining the amount and timing of losses from Ponzi-type investment schemes, which is difficult and dependent on the prospect of recovering the lost money (which may not become known for several years)) and Rev. Proc. 2009-20 (simplifying compliance for taxpayers by providing a safe-harbor means of determining the year in which the loss is deemed to occur and a simplified means of computing the amount of the loss).

⁷ Many tax professionals have posited that the deposit could be considered analogous to a securities loan (i.e., a transfer of property in exchange for an obligation to return identical property on demand), which would arguably be a nontaxable disposition.

⁸ All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), and the Treasury regulations promulgated thereunder, unless otherwise indicated.

⁹ §1001(a); Reg. §1.1001-1(a).

¹⁰ *See* Part I, “Celsius Bankruptcy and Recent Ruling,” above.

If a Taxable Event, What Are the Tax Consequences?

Given the bankruptcy court's ruling and the analysis above, Earn account holders recognized gain or loss upon transferring their cryptocurrency into an Earn account. This gain or loss would be calculated using the cost basis of the transferred crypto units (i.e., the amount the account holder paid for them) measured against the value the account holder received at the time of the transfer (likely just the fair market value of the transferred units at that time).

This exchange seems incredibly one-sided, because Earn account customers would appear to receive very little in exchange for their deposit. Economically, Celsius takes ownership of the deposited units and the customer receives Celsius debt in the form of a promise to return the deposited units at a future date. This contract has value equal to the amount of the deposit.¹¹ For tax purposes, the customer no longer owns the deposited cryptocurrency and instead owns Celsius debt in the form of a contractual agreement requiring Celsius to return the deposited cryptocurrency at some future date. The value of the Celsius debt will equal the amount of the customer's deposit (i.e., the customer's acquisition cost basis).

Potential Tax Deductions

Earn account customers will likely be able to claim a tax deduction on some future date associated with any loss suffered from the bankruptcy. As stated above, Earn account customers are now unsecured creditors and are unlikely to recover their full deposits, but before they may claim a loss deduction for tax purposes the Code requires that the amount of the loss be offset by any recovery through insurance or otherwise.¹² Because of the offset requirement, Earn account customers must wait until their loss can be determined with reasonable certainty before any deduction can be taken. Importantly, the bankruptcy court's ruling is favorable because it fixes the initial amount of an Earn account customer's loss as the amount of their deposit (or more specifically, the value of the Celsius debt received in exchange for the deposit). When Earn account customers receive a recovery in the Celsius bankruptcy (if any), that recovery will reduce the amount of the customer's taxable loss.¹³

Once an Earn account customer can identify their tax loss with reasonable certainty, they must deter-

¹¹ For example, if a unit of Ethereum that was purchased for \$500 is transferred into an Earn account with a value of \$1,300, the value received by the depositor would be \$1,300. For tax purposes, the \$1,300 received would be measured against the \$500 purchase price, resulting in \$800 of taxable gain.

¹² §165(a); see also Reg. §1.165-1(a).

¹³ For example, if an Earn account customer originally depos-

mine whether the loss is a capital or ordinary loss. Under the Code, loss deductions are generally considered ordinary losses and they can be applied to offset any income (business income, wages, etc.) with a maximum of \$3,000 available to offset ordinary income. The Code provides for three different categories of losses: (a) losses related to a trade or business; (b) losses related to a non-business transaction entered into for profit; and (c) losses related to a casualty event or theft.¹⁴

Given the nature of the Earn program and the bankruptcy court's ruling, Earn account customers would appear to be entitled to claim an ordinary loss relating to a non-business transaction entered into for profit, because the Earn program was created to allow users to deposit cryptocurrencies and receive weekly interest payments.¹⁵

Earn account customers might also be eligible to claim a nonbusiness bad debt deduction, which would be reflected as a capital (rather than an ordinary) loss.¹⁶ Nonbusiness bad debts must be totally worthless to be deductible, and the deduction may be taken only in the year the debt becomes totally worthless.¹⁷ This means that Earn account customers will likely have to wait until they receive a recovery (if any) in the Celsius bankruptcy proceedings before claiming a nonbusiness bad debt deduction.

ited \$1,300, but receives \$400 from the bankruptcy, then the deduction for a taxable loss will be limited to \$900 (\$1,300 initial loss minus \$400 recovery).

¹⁴ §165(c).

¹⁵ For various reasons, claiming a loss relating to a non-business transaction entered into for profit will be easier than claiming a theft or casualty loss. To claim a theft loss deduction under the Code, a taxpayer must show that the taking at issue was illegal under state law and was committed with criminal intent. While the New York State Attorney General has filed a lawsuit against Celsius CEO, Alex Mashinsky, alleging fraud and misrepresentation, the lawsuit is a civil action and does not allege criminal intent. Separately, for tax years 2018 through 2025, personal casualty losses (including losses from theft of personal property) are deductible only to the extent that such losses are attributable to federally declared disasters. See §165(h)(5), added by the 2021 Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, §11044.

¹⁶ §166(d). A nonbusiness bad debt is reported as a short-term capital loss on Form 8949, *Sales and Other Dispositions of Capital Assets*, Part 1, line 1.

¹⁷ A debt becomes worthless when the surrounding facts and circumstances indicate there is no reasonable expectation that the debt will be repaid. See *Crown v. Commissioner*, 77 T.C. 582, 598 (1981) ("There is no standard test or formula for determining worthlessness within a given taxable year; the determination must depend upon the particular facts and circumstances of the case. . . . However, it is generally accepted that the year of worthlessness is to be fixed by identifiable events which form the basis of reasonable grounds for abandoning any hope of recovery.") (internal citations omitted).

KEY TAKEAWAYS

Beyond the immediate consequences for interest-bearing Earn account holders in the Celsius bankruptcy, the bankruptcy court's recent ruling is not binding on ownership disputes in other recent insolvency cases, including FTX, Voyager, and BlockFi, although the ruling could prove influential. The resolution of similar disputes in the other cases will be fact-specific and will depend, in part, on the express language of the user agreements employed by those exchanges. FTX, for example, imposed "terms of service" which likely preserved account holders' ownership of their deposited assets. Those terms specified that "Title to your Digital Assets shall at all times remain with you and shall not transfer to FTX Trading;" "None of the Digital Assets in your Account are the property of, or shall or may be loaned to, FTX Trading;" and "You control the Digital Assets held in

your Account."¹⁸ Based on these terms, FTX account holders may avoid the situation Celsius Earn account holders have encountered.

The ownership dispute relating to the Celsius Earn accounts highlights the importance of reviewing user agreements and other information when interacting with centralized exchanges. In the current regulatory climate and with very little transparency into the management of centralized exchanges, one can never be too careful.

For now, Earn account customers should wait for clarity around the recovery (and resulting tax treatment) of their losses in the Celsius bankruptcy. Earn account customers should also monitor the possibility of interim relief or guidance from the IRS and consult a tax professional to prepare for the upcoming tax return cycle.

¹⁸ *FTX Violated Its Own Terms of Service and Misused User Funds, Lawyers Say*, CoinDesk (Nov. 10, 2022), <https://www.coindesk.com/policy/2022/11/10/ftx-violated-its-own-terms-of-service-and-misused-user-funds-lawyers-say/>.