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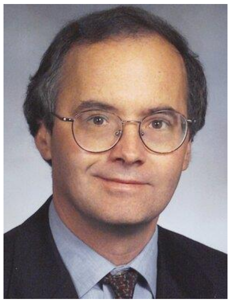
Digital Taxation Is Necessary, But Tough To Manage

By **Mark Howe, Linda Swartz and William Walsh** (October 6, 2022, 1:03 PM EDT)

Since the arrival of bitcoin in 2009, the digital economy has seen a meteoric expansion.



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By many estimates, cryptocurrencies and digital assets currently exceed $3 trillion worldwide. Further, the digital economy is characterized by increasing technical sophistication and innovation, with new digital assets constantly emerging and the functions of traditional financial intermediaries being increasingly replicated and automated digitally.

The initial international concern regarding digital transactions focused on the potential for money laundering and preventing the digital economy from devolving into a haven for worldwide tax fraud and evasion.

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More recently, the U.S., including the executive branch, the legislature and administrative agencies, has begun to address other emerging issues — including tax — posed by the digital economy, especially cryptocurrencies. In particular, President Joe Biden's administration, the U.S. Senate and the U.S. Department of the Treasury, including the Internal Revenue Service, have issued directives, proposals and basic guidance in this area.

The areas of tax uncertainty involving the digital economy are myriad, but a few of the areas most acutely in need of guidance include:

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- The extent to which existing tax rules could — or even should — be extended to digital transactions as opposed to creating sui generis approaches for digital assets;
- Proper tax reporting for digital transactions;
- The development of sourcing rules for the digital economy that would rationalize national level taxation of transactions that may have connections to multiple jurisdictions — or perhaps to no jurisdiction at all; and

- A range of substantive tax issues posed both by the intrinsic nature of digital assets and the use of digital transactions— including decentralized finance transactions — to bypass the traditional role of regulated financial intermediaries.

Sui Generis or Analogous? How to Tax Cryptocurrency

A threshold question is whether to apply or extend existing rules governing the taxation of analogous nondigital transactions when determining the tax consequences of digital transactions, or whether to develop a wholly new system for taxing these unique assets.

Applying the correct tax analog to digital assets depends in part on the current debate between the U.S. Securities and Exchange Commission and Commodity Futures Trading Commission whether and which digital assets are viewed as securities or commodities.

The current focus of IRS guidance and proposed tax legislation in the U.S. appears to be an extension of existing rules approach to taxing digital transactions. This approach has in large part been followed by the IRS in various notices, rulings and other guidance. This includes notable non-IRS proposals including the Biden administration's general explanations of its fiscal year 2023 revenue proposals, known as the Greenbook, and the proposed Lummis-Gillibrand Responsible Financial Innovation Act.

Yet, even under this approach, choosing the correct analogy is open to debate and significant uncertainty persists regarding the precise manner that existing rules should be applied or extended to their digital analogs.

Reporting Regimes

Cryptocurrency market participants — particularly intermediaries and miners — are wary of potential reporting obligations for cryptocurrency transactions, while the government has countervailing concerns that the decentralized nature of cryptocurrency transactions will facilitate money laundering and tax evasion.

The IRS has provided guidance that taxpayers must report income, gain or loss from all taxable cryptocurrency transactions irrespective of whether they received the requisite information returns. Recent changes, including the inclusion of cryptocurrency-specific language on IRS Form 1040 — the U.S. individual income tax return — as well as subjecting persons that provide services effectuating transfers of digital assets to mandatory reporting rules otherwise applicable to brokers, are indicative of the U.S. commitment to uncovering and taxing cryptocurrency transactions.

To this end, the Greenbook proposed rules requiring further information reporting for certain intermediaries and cryptocurrency holders in line with noncryptocurrency transactions. The act would clarify and narrow the reporting regime for brokers, discussed above, to persons engaged in the ordinary course of a trade or business of effecting sales transactions for customers, which may exclude from the tax reporting regime cryptocurrency miners, validators and software and hardware developers.

There are, however, some features of cryptocurrency reporting that are more difficult to analogize. An example of such uncertainties is found in decentralized autonomous organizations, or DAOs, which are a form of entity arising from the advent of blockchain with decentralized decision making and governance processes. The tax reporting obligations for these entities are unclear. The act would generally treat DAOs as entities as subject to tax return filing requirements.

Likewise, taxpayers are increasingly utilizing cryptocurrency for everyday transactions. Holders of appreciated cryptocurrency utilizing cryptocurrency to pay for everyday items such as coffee or gas may be required to recognize and be expected to track gains on these transactions.

While this treatment is in line with other forms of property, the increased acceptance by merchants of cryptocurrency as a method of payment means that everyday users of cryptocurrency may have increasingly burdensome filing and reporting requirements. Recognizing that it would be administratively burdensome for taxpayers to track these amounts, multiple legislative proposals would provide for a de minimis exception for small personal cryptocurrency transactions.

Development of Sourcing Rules for a Digital Economy

The digital economy can play havoc with traditional sourcing of income rules as well. Digital assets may:

- Have no clear situs;
- Be digital representations of tangible assets;
- Be transferred between parties in circumstances where the jurisdiction of title passage is indeterminate;
- Be transferred in circumstances where intermediaries or agents are involved and potentially create taxing nexus attributable to the actions of such intermediaries; or
- Involve situations where amounts are received for facilitating a digital transaction where the location, purpose and nature of the payment are uncertain.

From a U.S. tax perspective, income that does not fit cleanly into one of the specifically defined sourcing rules is generally sourced by analogy. But this approach by itself is highly problematic in a digital context since the specific nature of the income and the mechanism generating it are often indeterminate.

For instance, certain cryptocurrencies determine validation rights based on a proof-of-stake protocol whereby the validator receives a staking reward for performing the validation. Such a staking reward has aspects of both a compensatory payment for the validation service and a passive income aspect based on the amount of currency that the validator had to stake to obtain the validation right together with downside risk associated with market fluctuations on its staked cryptocurrency.

Determining how such payments should be sourced by analogy is challenging at best. This illustrates the need for specific guidance that sets definitive sourcing rules specific to particular digital transactions.

As a further example, foreign investors may be concerned that activities undertaken to facilitate their investment in cryptocurrency could generate so called effectively connected income that would subject foreign investors to U.S. net income taxation on their cryptocurrency income effectively connected to a U.S. trade or business.

Pursuant to Internal Revenue Code Section 864(b)(2), foreign persons who satisfy trading safe harbors may trade in certain securities or commodities without the risk of their activities giving rise to a U.S. trade or business and subjecting them to U.S. net income taxation on that income.

Currently, both the act and the Greenbook include proposals for expanding the trading safe harbors to include cryptocurrency.

Substantive Tax Issues Requiring Clarity

Taxpayers who determine that their holdings of cryptocurrency create income subject to U.S. taxation or who believe they are subject to U.S. reporting requirements need to ascertain by analogy how existing tax laws impact their situation.

In areas where the IRS has refrained from providing or has provided conflicting guidance, legislation has been proposed that may provide clarity for taxpayers. Although this list is not exhaustive, it represents a high-level overview of the current proposals that may impact market participants when reporting their tax obligations.

Uncertain Tax Treatment of Staking and Mining, Forks and Wrapped Cryptocurrency

The tax implications from staking and mining are unclear.

Cryptocurrency requires a validation process, which may give rise to tax. As discussed above, proof-of-stake validation typically provides validators with staking rewards. Alternatively, a cryptocurrency may utilize proof-of-work validation whereby miners validate transactions by solving certain puzzles and in doing so receive units of cryptocurrency as reward.

The IRS indicated that a taxpayer that successfully mines cryptocurrency must include the fair market value of the cryptocurrency received as a reward for its mining activities on the date received. By contrast, the IRS has yet to provide any guidance regarding the taxation of rewards for staking, which has resulted in taxpayers taking a variety of positions.

The act would reject the IRS' treatment of mining and provide that digital assets generated from mining and staking activities are not taxable upon creation but rather are excluded from gross income until the disposition of those assets.

Forks are changes in a cryptocurrency's protocol that may cause the blockchain to split into new and legacy ledgers — a hard fork — or may result in the existing blockchain simply continuing without interruption under the rules of the revised protocol — a soft fork. The IRS has issued guidance that soft forks do not give rise to taxable income, while hard forks may give rise to taxable income when the taxpayer has dominion and control over the cryptocurrency in the new ledger.

However, the IRS guidance does not encompass all situations that may arise in connection with forks and as a result owners of cryptocurrency and other market participants may be left wondering whether they need to report taxable income due to any particular protocol change.

Wrapping is the process whereby a holder of one cryptocurrency can convert its cryptocurrency to a form that is accessible on another cryptocurrency's blockchain. Generally, this requires the holder to transfer its current cryptocurrency to a merchant that provides new tokens that are compatible with the new blockchain and stores the transferred tokens until redeemed at a later date.

Whether wrapping is viewed as a taxable exchange has not been resolved.

Cryptocurrency Lending

The IRS is becoming increasingly concerned about the lending of cryptocurrencies given the increasing depth of the market and widespread involvement by unsophisticated retail participants. Yet there is limited guidance from the IRS addressing the tax implications of cryptocurrency lending, and specifically whether the placement of cryptocurrency for lending gives rise to a gain for the lender.

Increasingly, there are platforms where cryptocurrency holders can lend their cryptocurrency and receive an interest return thereon, including in decentralized finance transactions where parties enter into traditional financial transactions — e.g., borrowing digital assets, insuring risk or even entering into derivatives — without the participation of a traditional financial intermediary and the results of the financial transaction are automatically settled by digital asset transfers through the use of autonomous software.

Often, decentralized finance transactions are effected on a pooled basis where numerous (and often changing) participants may be participating in the transaction at any point in time, which implicates reporting as well as sourcing issues as discussed above.

The IRS has issued guidance that cryptocurrency should be treated as property for tax purposes. Consequently, a loan of cryptocurrency may constitute a taxable disposition of the asset, followed by a reacquisition when the loaned cryptocurrency is returned. Guidance is needed to equate the taxation of such digital financial transactions with their traditional analogs, while providing the transparency and tracking required for efficient tax administration.

Both the act and the Greenbook would expand the rules of Section 1058 to cover loans of cryptocurrencies. Under Section 1058, loans of securities do not result in the recognition of gain or loss — either on initial transfer or return — if made pursuant to agreements that meet certain requirements. A lender of cryptocurrency would include the same income as if they held the loaned digital asset directly.

Application of Mark-to-Market Rules

Certain commodities dealers and traders have the ability to elect mark-to-market treatment, and in doing so, are deemed to have sold all their positions for the fair market value thereof on the last day of the calendar year.

Although the IRS has not issued guidance whether the mark-to-market rules under Sections 475(e) and (f) apply to holders of cryptocurrency, the Greenbook would allow dealers and traders respectively in cryptocurrency to elect mark-to-market treatment with respect to certain actively traded cryptocurrency held by the dealer or in the trading business of the trader.

Application of Straddle Rules

There is uncertainty whether cryptocurrency transactions are subject to the straddle rules of Section 1092, which act to limit a taxpayer's ability to utilize losses arising from offsetting positions in personal property that is actively traded.

The definition of actively traded is quite broad and could encompass certain cryptocurrency exchanges.

Absent clear guidance on this point, cryptocurrency holders may find themselves subject to the straddle rules.

Uncertain Tax Status of Stablecoin

Market participants keen on reducing the volatility associated with cryptocurrencies have devised so-called stablecoins, which are cryptocurrencies that are generally tied to a fiat currency such as the U.S. dollar or commodities such as gold. In theory, the issuer of stablecoins holds reserves designed to prevent price fluctuations.

The tax classification of stablecoins is uncertain with different iterations of stablecoins providing varied rights. For tax purposes, the treatment of the issuance of a stablecoin is unclear and, among others, could be viewed as debt vis-à-vis the stablecoin holder as well as a right to the underlying reserves.

Charitable Crypto Donations

The IRS has provided guidance that taxpayers who make charitable contributions to an organization enumerated in Section 170(c) will not recognize income, gain or loss on the contribution and will generally have a charitable deduction equal to the fair market value of the cryptocurrency at the time of contribution if the cryptocurrency is held for more than one year.

In the alternative, if held for a year or less, the deduction is equal to the lesser of basis or the fair market value at the time of contribution. Whether other restrictions limit the deductibility of charitable contributions of cryptocurrency is unclear.

As an example, the act would provide an allowance for charitable contributions of digital assets greater than $5,000, that are traded on established financial markets, as readily valued property and in doing so would remove appraisal requirements under Section 170(f)(11)(A).

The foregoing has merely scratched the surface of the significant tax issues surrounding the digital economy. The digital economy is thriving, but its continued growth and development depend on putting in place well considered tax guidelines that will facilitate the growth of the digital economy while protecting investors and the government's finances as well.

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