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Legal Update

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United States: Senate Shows Interest in Crypto Taxation

Tax News and Developments

In brief

The United States Senate this past week solicited input from the public on the appropriate treatment of digital assets under US federal income tax law. Noting that uncertainty over the application of existing laws to transactions involving digital assets creates complex tax reporting issues for taxpayers, the Senate signaled that legislation may be required to provide adequate guidance to the industry and the public.

In depth

On 11 July 2023, Chairman Ron Wyden and Ranking Member Mike Crapo of the Senate Committee on Finance penned an open letter to members of the digital asset community and other interested parties requesting assistance in helping Congress understand how to address various tax issues related to the taxation of digital assets (the "Senate Finance Letter"). This letter presented a series of questions addressing the tax challenges and opportunities presented by digital assets. These questions were based on a report prepared by the Joint Committee on Taxation in response to an earlier request from the Senate Finance Committee (the "JCT Report").

The core issue raised by the JCT Report is the continued uncertainty over the tax characterization of digital assets. For example, the IRS concluded in Notice 2014-21 that "convertible virtual currency" should be treated as property, but not currency, for US federal income tax purposes. But various provisions of the Internal Revenue Code (IRC) afford different tax treatment to different types of property, and there is inadequate guidance on how digital assets should be characterized for purposes of these tax provisions. The JCT Report then identified a number of tax issues posed by digital assets, and the Senate Finance Letter then posed a series of questions related to the issues raised in the JCT Report.

One day after the Senate Finance Letter was published, Senators Cynthia Lummis and Kirsten Gillibrand introduced the Lummis-Gillibrand Responsible Financial Innovation Act (RFIA). The bill, which is a revised version of a 2022 bipartisan bill sharing the same title (*see* S. 4356, 117th Cong.), is intended to “provide consumer protection and responsible financial innovation, to bring crypto assets within the regulatory perimeter,” and to achieve other related objectives. Sections 801-809 of the RFIA set forth a number of tax legislative proposals, seven of which overlap with the questions posed in the Senate Finance Letter.

What follows is a brief discussion of the issues that were identified in the JCT Report, raised as questions in the Senate Finance Letter, and/or addressed in legislative proposals in the RFIA.

Marking-to-Market for Traders and Dealers

IRC section 475 requires dealers in securities to recognize gain or loss, generally of ordinary character, on the securities held at year-end under the mark-to-market accounting method. A voluntary mark-to-market election is also available to dealers in commodities and traders in securities or commodities.

The JCT Report notes that it is unclear whether digital assets are within the scope of section 475. The legislative history to section 475 indicates, however, that this method of accounting is appropriate for frequently traded assets with determinable market values. Many digital assets are frequently traded on centralized and/or decentralized exchanges, and consequently have determinable market values. Therefore, the Senate Finance Letter asks for comments on whether the mark-to-market accounting rules should apply to traders and dealers of digital assets, whether the answer should depend on the type of digital assets, and how to determine when a digital asset is actively traded.

Section 806 of the RFIA would include crypto assets within the definition of the term “commodity” and consequently bring crypto assets within the scope of the elective section 475 mark-to-market accounting rules.

Trading Safe Harbor

Under the safe harbor rule of IRC section 864(b)(2), foreign traders in stock, securities, or commodities are not treated as engaged in a "US trade or business," and thus are not taxed on the income that would otherwise be effectively connected with such US trade or business, so long as they do not maintain an office or other fixed place of business in the United States through which their trading activities are effected. Instead, the foreign traders are generally subject to a gross-based 30% withholding tax, with the rate frequently reduced under a relevant tax treaty. This safe harbor rule encourages foreign investment in US capital markets.

The JCT Report notes that the treatment of digital assets as securities or commodities for purposes of the safe harbor rule is unclear under current law. The Senate Finance Letter then poses the question of whether the existing safe harbor, which encourages foreign investment, should apply to digital assets as well, or if, alternatively, a separate safe harbor should apply.

Section 803 of the RFIA would extend the safe harbor rules to foreign traders in crypto assets. Trading in crypto assets through a resident broker, commission agent, custodian, crypto asset exchange, or other independent agent would be excluded from the definition of US trade or business under section 864. Trading in crypto assets for the taxpayer's own account would be similarly excluded, except in the case of a dealer in crypto assets.

Treatment of Loans of Digital Assets

Lending of securities, if performed under an agreement that complies with certain requirements of IRC section 1058, does not require the lender to recognize any gain or loss on the lending or return of the security. Generally speaking, the only income taxable to the lender in this instance is the compensation received from the borrower.

By its terms, section 1058 only applies to the lending of securities, and the JCT Report observes that it is unclear whether digital assets might qualify as securities for purposes of this provision, or for analogous treatment under the law that preceded the enactment of section 1058. The Senate Finance Letter requests descriptions of existing digital asset loan transactions, and confirmation of whether these transactions would use a loan agreement that would otherwise meet the requirements of section 1058. The letter also questions whether section 1058 should apply to all digital assets or a subset of digital assets, and what practical challenges might result from applying section 1058 to digital assets.

Section 804 of the RFIA would amend section 1058 to include certain crypto assets within the definition of "securities" for purposes of section 1058. However, no inference is intended with respect to the classification of any crypto asset as a security for securities law purposes.

It is also worth noting that DeFi protocols and apps have very diverse features and may, in certain circumstances, not meet the requirements of section 1058, even if the crypto asset that is the subject of the lending transaction would otherwise qualify as a security for purposes of section 1058. Rules recently proposed by HMRC in the UK would treat the lending of crypto tokens as outside the scope of capital gains taxation, a rule roughly analogous to what is proposed in section 804 of the RFIA. The UK rule would not apply to a transaction in which the lender does not receive back the same quantity of the same type of tokens that were originally lent. HMRC acknowledged that many DeFi transactions, such as the lending of tokens to a liquidity pool, would therefore fall outside the scope of these rules and will require further study. For a discussion of HMRC's "Consultation on the taxation of decentralized finance (DeFi) involving the lending and staking of cryptoassets", see our previous client alert.

Wash Sales

IRC section 1091 prohibits the recognition of loss on the sale of stock or securities if, within a period from 30 days before the sale to 30 days after the sale, the seller acquires substantially identical stock or securities (commonly referred to as a "wash sale"). Instead, the basis of the asset is adjusted by the amount of the disallowed loss, effectively postponing the recognition of the loss until the repurchased asset is sold. Absent section 1091, taxpayers could recognize a tax loss on the sale of a depreciated security, but effectively retain ownership of the loss-producing asset.

The JCT report highlights that digital assets are not expressly covered by section 1091. The Senate Finance Letter asks whether section 1091 should apply to digital assets and whether there are other legal doctrines under which transactions in digital assets might be considered equivalent to a wash sale.

Section 805 of the RFIA makes a number of changes to section 1091, including expanding the scope of the wash sale rules to cover actively traded crypto assets, any notional principal contract with respect to any such crypto asset, and any evidence of an interest in, or derivative instrument in, any such crypto asset or notional principal contract, including any option, forward contract, futures contract, short position, and similar instrument in such a crypto asset.

Constructive Sales

A taxpayer is required under IRC section 1259 to recognize gain on constructive sales of "appreciated financial positions" as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Section 1259 defines "constructive sale" as any one of a number of enumerated transactions that effectively terminate the taxpayer's economic ownership of the appreciated asset.

The JCT Report notes that digital assets are not expressly covered under section 1259. The Senate Finance Letter asks whether section 1259 should apply to digital assets and whether there are other legal doctrines under which transactions in digital assets might be considered equivalent to a constructive sale.

The RFIA does not include a legislative proposal relating to constructive sales of digital assets.

Exclusion of De Minimis Gains

Ordinarily, transactions in which a taxpayer is entitled to receive or obligated to pay an amount denominated in nonfunctional currency can give rise to foreign currency gain or loss under IRC section 988, and this gain or loss is treated as ordinary interest income or expense. However, treatment as foreign currency gain or loss does not apply to personal transactions, which are transactions by individuals unless related to trade or business expenses under section 162 or expenses for the production of income under section 212. Furthermore, no gain is recognized by reason of changes in exchange rates on any personal transaction unless the gain that would otherwise be recognized on the transaction exceeds $200.

According to the JCT report, because digital assets are not treated as currency, the sale or other disposition of digital assets, unlike the disposition of financial positions in foreign currency, does not generate any foreign currency gain or loss. The Senate Finance Letter asks whether a de minimis nonrecognition rule should apply to digital assets as well.

Section 801 of the RFIA would exclude from gross income gain from the sale or exchange of any crypto asset where neither the total value of the sale nor the gain otherwise recognized on the sale exceeds $200. The exception would not apply to a sale or exchange for (1) cash or cash equivalents, (2) property used by the taxpayer in the conduct of a trade or business, or (3) property held by the taxpayer for the production of income.

Timing and Source of Income Earned from Staking and Mining

Generally speaking, the receipt of property in exchange for services is taxable as ordinary income at the time of receipt in an amount equal to the fair market value of the property when received. That said, income from certain self-created property is not realized until the property is sold or disposed of.

In Notice 2014-21, the IRS concluded that virtual currency received in consideration for mining should be included in income when received, and should be treated as self-employment income if the mining activity constitutes a trade or business. The JCT Report notes that this is the normal treatment for property received for services, and posits that this reasoning should also apply to digital assets that are received in consideration for staking. At least one taxpayer has challenged this conclusion in court, and the proper tax treatment of mining and staking is still an open question. The Senate Finance Letter requests a description of the various rewards provided for mining and staking, how they should be taxed, the character of the income, the source of the income, and when a taxpayer should be considered to be in the trade or business of mining or staking.

Section 808 of the RFIA would defer income recognition for taxpayers that conduct crypto mining or staking activities. The legislation would amend IRC section 451 to provide that the amount of income relating to such activities shall not be included in the gross income of the taxpayer until the taxable year of the sale or other disposition of the assets produced or received in connection with the mining or staking activities.

FATCA and FBAR Reporting

Under the Bank Secrecy Act, US citizens, residents, and persons doing business in the United States are required to file a Report of Foreign Bank and Financial Accounts (FBAR) with respect to certain transactions and accounts with foreign financial entities. Failure to properly report can result in substantial criminal and civil penalties. The Foreign Account Tax Compliance Act (FATCA) requires certain foreign financial institutions to collect and report certain financial information with respect to accounts held by US individuals.

The JCT Report observes that neither FBAR nor FATCA reporting guidance expressly address the reporting of digital assets. Although the Bank Secrecy Act was recently amended to confirm authority to regulate digital assets, to date FinCEN has not revised FBAR reporting guidance to encompass digital assets. The Senate Finance Letter asks for comments on whether taxpayers should be required to report digital assets on their FATCA and FBAR forms, and if so, when they are required to do so. The letter also questions whether the rules should be clarified to show when reporting requirements are necessary, given the policy reasoning behind FATCA and FBAR.

The RFIA does not include a legislative proposal relating to FATCA and FBAR reporting for digital assets.

Valuation and Substantiation

With certain exceptions, deductions are generally allowed under IRC section 170 for charitable contributions of property other than cash in an amount equal to the fair market value of the contributed property. Contributions of noncash property in excess of $5,000 must be supported by a qualified appraisal, and the appraisal must be attached to the tax return if the value of the contributed noncash property exceeds $500,000. The appraisal requirement does not apply to certain contributions of readily valued property, which includes securities for which market quotations are available on an established securities market.

The JCT Report notes that IRS Office of Chief Counsel, in a January 2023 memorandum, concluded that cryptocurrency was not a security traded in an established securities market, and therefore did not qualify as a readily valued asset for purposes of the exception to the section 170 appraisal requirement. The Senate Finance Letter asks whether digital assets should qualify for the exception related to assets with a readily available valuation on an exchange, and if so which digital assets and exchanges should qualify.

Section 809 of the RFIA would exempt actively traded crypto assets from the appraisal requirements under section 170. For this purpose, the bill defines "crypto assets", but does not appear to provide any detail on what might qualify as "actively traded" crypto assets.

Information Reporting Requirements on Crypto Asset Brokers

For periods after 31 December 2023, IRC section 6045(g) imposes certain information reporting requirements on "brokers" with respect to digital assets. For this purpose, a broker is defined as "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."

The JCT Report acknowledges concerns that this definition is too broad, and that "ancillary parties who cannot get access to information that is useful to the IRS are not intended to be captured by the reporting requirements for brokers. For example, persons who are just validating transactions through a consensus mechanism are not likely to know whether a transaction is part of a sale." The Senate Finance Letter did not request comments on this provision.

Section 802 of the RFIA would amend the definition of broker under section 6045(c) to include “any person who (for consideration) stands ready in the ordinary course of a trade or business to effect sales of crypto assets at the direction of their customers.” This should reduce the concern that the broker reporting requirements might be inappropriately applied to individuals or entities that merely facilitate the operation of blockchains or protocols but have no relationship to customers engaging in crypto asset transactions.

Timing and Source of Income Related to Forks, Airdrops, and Other Subsidiary Value

Finally, section 807 of the RFIA addresses the tax treatment of forks and airdrops, which were discussed in prior IRS guidance, including Rev. Rul. 2019-24. Neither the JCT Report nor the Senate Finance Letter sought to address these situations. The RFIA provides that the value of any "applicable asset" (*i.e.*, a crypto asset fork, crypto asset airdrop, or other form of subsidiary value relating to a crypto asset) which a taxpayer receives and for which the taxpayer has taken affirmative steps relating to the control of such asset, is includable in the taxpayer’s gross income as ordinary income in the taxable year in which such asset is sold or otherwise disposed of. This is contrary to the position taken by the IRS in prior guidance, but is broadly consistent with the treatment of mining and staking rewards in section 808 of the RFIA.

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