Charting The Course For Digital Assets In 2024

By **Joshua Smeltzer** (January 1, 2024)

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As the price of bitcoin rises, it is dominating the discussion regarding the future of cryptocurrencies, other digital assets, and blockchain technology. Although the bitcoin price is a good thing, there is much more to be excited about regarding blockchain technology and digital assets in 2024.

As 2024 begins, a lot of the baggage surrounding digital assets is becoming history, allowing the industry to move on from a year full of negative headlines and negative activity in the digital asset space. Although there will always be some fraud in the digital asset industry, that is also true of traditional assets.

Fraud is an unfortunate, but consistent, aspect of financial transactions. It will never be eliminated entirely, but it can be minimized. With the trial and eventual conviction of Sam Bankman-Fried in November 2023, the public has started to see a light at the end of the tunnel regarding the barrage of claims that digital assets are consumed with opportunity and actual fraud.

The trial of Bankman-Fried helped publicize that most of the fraudulent activity was not unique or novel but, instead, involved the types of false statements and fictional representations typical in other fraud cases. Although a large-scale fraud using a new unique asset, the activity was not really that unique.

Throughout 2023, the industry and governments used reports of fraud as a platform to discuss what protections could prevent or minimize future fraudulent activity.

Internationally, many countries have implemented reporting requirements for digital assets established by the Organization for Economic Cooperation and Development to help identify the movement of digital assets and report it to the government to investigate.

Here in the U.S., the Internal Revenue Service finally issued hundreds of pages of proposed regulations regarding information reporting and, following those proposed regulations, indicated that it would also adopt the OECD standard sometime in the future.

The full impact, and the final version of the IRS regulations, will not be known until later this year, and pending or new legislation may affect that reporting as well. However, I offer the following observations about the outlook for digital assets this year.

Fraud is being controlled and, more importantly, is controllable.

The U.S. announced charges against FTX founder Bankman-Fried about a year ago.[1] On Nov. 2, 2023, U.S. Attorney Damian Williams announced the guilty verdict on seven counts of fraud and said that he "perpetrated one of the biggest financial frauds in American history."[2]

Attorney General Merrick Garland added that the verdict sent a clear message that the U.S. Department of Justice would come after "anyone who tries to hide their crimes behind a shiny new thing they claim no one else is smart enough to understand."[3]

As the self-appointed king of cryptocurrency, it was a shock when Bankman-Fried was indicted and an even bigger shock that the accusations appeared to be true as the evidence was uncovered. Other frauds were uncovered throughout 2023, but this conviction seemed to, right or wrong, take center stage.

The DOJ, the U.S. Securities and Exchange Commission, the IRS and other agencies also started initiatives and set up enforcement arms during 2023. President Joe Biden specifically asked all administrative agencies to consider and implement proper procedures regarding digital assets. Essentially, the government took notice of the need to have a plan with regard to digital assets.

The IRS, in particular, set up the Office of Fraud Enforcement, which has several functions and is charged specifically with enforcement regarding digital assets. The SEC filed multiple lawsuits against cryptocurrency exchanges, and digital asset companies filed lawsuits against the SEC, trying to push for approval of certain financial products allowed for traditional assets. The DOJ also expanded its enforcement efforts against fraud involving digital assets to a nationwide network.

The public, for the most part, has accepted that the government is now watching digital asset transactions and that awareness will cause people to consider those transactions carefully. Also, prosecutions of truly bad actors who are falsifying information, hiding assets or otherwise operating dishonest businesses will help those operating real businesses in the digital assets space find comfort in that they are not at a competitive disadvantage for coloring within the lines.

The problem is that the lines are still not clear. Although the world and the U.S. have started to implement legislation, most of it is still proposed or pending and not definitive. The first court decisions started to come out in 2023, but decisions are still sparse and many are being appealed, such that they are not final decisions. Also, many decisions were made in bankruptcy court, which is a unique forum with its own special purposes and rules.

In 2024, continued litigation regarding digital assets will add to the body of law on which practitioners can rely, and earlier decisions will become final and unappealable. This will help draw lines in an industry that currently doesn't have clear rules.

Also, proposed regulations will become final this year and pending legislation may finally become law, such that both the government and the industry can rely on them going forward. The rules aren't here yet, but there is enough out there to know that a set of rules is possible and will be implemented eventually. This is a good thing for the industry, because clear rules are needed to grow and operate with acceptable and known risk.

For example, as the FTX bankruptcy is winding down, it is still unknown what recovery may be available for the victims of the fraud. Usually, taxpayers who do not receive a full recovery can get some relief by claiming theft losses on their tax returns, mitigating the financial impact. These provisions were put in place following the large financial fraud involving Bernie Madoff, who pled guilty in 2009.

However, the Tax Cuts and Jobs Act removed that benefit to pay for other provisions in the Internal Revenue Code. Absent unique facts and arguments, most of those theft losses are no longer available and appear to force taxpayers to bear the full brunt of the financial loss. This is just one of many example of tax rules not providing clarity for potential victims of fraud with real losses involving digital assets.

Governments are casting a wide net that will need to be narrowed.

Governments around the world and the U.S. have the same problem; they don't know all the activities occurring with digital assets. This is primarily a result of its being a technology and an asset class that is both everywhere and nowhere at the same time.

The blockchain technology exists on the internet and is accessible everywhere there is a connection, and doesn't allow for distinct compartmentalization of the information stored on that blockchain. This is the reason for international cooperation in the reporting standards for digital asset transactions. The U.S. recently announced that it intends to adopt those international standards in addition to recently issued IRS proposed regulations.

Unfortunately, both the OECD reporting standard and the IRS proposed regulations essentially gather anything and everything that is connected to digital assets. Although the promised exclusion of bitcoin mining from the reporting requirements was put in the proposed regulations, almost every other transaction and type of digital asset was included.

The proposed regulations require transaction reporting for both non-fungible tokens and decentralized finance transactions. The broad scope has caused the U.S. Department of the Treasury and others to estimate that the potential 1099-Digital asset reporting requirement could result in as many as 8 billion informational returns. This is clearly unworkable from a processing perspective, even with the benefit of sophisticated analytics software.

Also, such a high volume begs the question whether there is too much duplication or too broad a scope outlined in the proposed regulations. Many commenters on the proposed regulations objected to the scope and suggested a narrower focus for informational reporting. It remains to be seen how the IRS will treat those comments and what changes might be made to the proposed regulations when they are finalized.

The U.S. was, prior to this regulation, forced to seek multiple John Doe summonses from cryptocurrency exchanges and other companies individually and with court approval. That system was also unworkable, but the pendulum appears to have swung too far in the other direction, creating a compliance burden that is too high for most modest digital asset companies and, perhaps, the big digital asset companies as well.

However, even if the compliance risk could be handled, the volume of informational returns cannot be handled by the IRS. If the pandemic taught us one thing about the IRS, it is that there is too much paper flowing through the agency and any hiccup causes severe problems in its processing. An influx of 8 billion informational returns is exactly the type of hiccup that could cause the same mistakes, lost returns, and incorrect notices and actions against taxpayers that we saw during the pandemic.

The blockchain and digital asset industry is expanding despite obstacles.

Given the fraud cases, and the increased government enforcement and scrutiny, one would think that the digital asset industry would be stagnant. However, the opposite appears to be the case.

Tokenization of real-world assets continues to expand and financial products involving digital assets are expanding as well. The decentralized finance industry, although concerned by recent IRS reporting regulations, has expanded despite the down economy. It continues to offer more and more flexibility and creative financial transaction opportunities to a wider audience. It will continue to expand as much as it can within the regulatory limits placed on it in the U.S. and internationally.

NFTs have moved beyond digital artwork and other items, which appear to have lost some luster during 2023. These unique digital assets are now being explored and, in some cases, implemented as a new way to represent interests in certain investment and business ventures.

Expect more creative uses of NFTs in 2024 as the industry tries to pivot from a waning market for digital art and other collectible-trading activity.

Conclusion

2023 was certainly a tough year for digital assets and the industry that supports them. However, there were also a lot of developments that indicate 2024 will be a good year for the industry.

Clarity for both legal and government enforcement issues will be provided through legislation, pending legislation and regulatory action, and decisions in cases currently being litigated throughout the country. Clearer rules should emerge in 2024, which will allow the industry to expand its activities, with more comfort that its actions will not be challenged.

The digital asset industry is fighting for its reputation, and for similar treatment as traditional assets and financial products are allowed. We can expect digital assets to expand and evolve as those cases are decided and the government decides what it will allow without challenge and what will still require a court to resolve. Either way, the additional clarity is welcome.

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[1] See https://www.justice.gov/usao-sdny/pr/united-states-attorney-announces-charges-against-ftx-founder-samuel-bankman-fried.

[2] See https://www.justice.gov/usao-sdny/pr/statement-us-attorney-damian-williams-conviction-samuel-bankman-fried.

[3] See https://www.justice.gov/opa/pr/attorney-general-merrick-b-garland-statement-guilty-verdict-jury-trial-sam-bankman-fried.