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A Close Look At The Decentralized Effort To Tax Digital Assets

By **Joshua Smeltzer** (July 14, 2022, 6:16 PM EDT)

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Cryptocurrency is no longer a new asset — it's been around since 2009 — and the number of individuals and businesses who own or use cryptocurrency, and the underlying blockchain technology, continues to increase with each passing year. Remarkably, the U.S. and most other countries are still only beginning to regulate the taxation of this "new" asset class.

Clarity on taxation, both internationally and domestically, is one of the biggest hurdles to mass adoption and use. With a total market cap of almost a trillion dollars, there is money to be made, but many remain hesitant without understanding the tax implications. Also, the emergence of NFTs and other uses of the underlying blockchain technology presents a potential economic opportunity not seen since the early days of the internet.

Governments are still, arguably, mainly focusing on reporting and enforcement in an effort to avoid tax evasion of their citizens. However, some countries are also starting to move beyond reporting and enforcement to create a conducive environment for development and operation of digital asset businesses.

Although this patchwork of current and proposed rules is far from uniform, it provides a glimpse into what worldwide regulation of digital assets, without a country of ownership or even true location, might look like in the future.

Why Governments Focus on Reporting and Enforcement

Oliver Wendell Holmes Jr. stated that "taxes are the price we pay for civilization."[1] In short, the benefit a government gets from a strong and vibrant digital asset economy is the ability to tax that income and use those taxes to improve civilized society.

However, a government cannot tax what it doesn't see — and that creates the incentive to hide income. This apparent invisibility is also the primary reason for societal assumptions that cryptocurrencies are currencies for criminals. However, countries struggled with citizens attempting to hide income offshore long before cryptocurrencies were created.

Although the problem is not necessarily new, the decentralized and entirely digital nature of cryptocurrency and other digital assets makes it easier for taxpayers to establish and keep accounts offshore. Traditional financial institutions are subject to extensive regulations and a host of applicable laws to prevent abuse, protect consumers and citizens, and allow for more efficient taxation of financial transactions.

Digital institutions are relatively new and, for the most part, not subject to the same rules — at least not yet.

Digital Asset FATCA or OECD Common Reporting Standard

The U.S. and the Organization for Economic Cooperation and Development both recently released proposals for digital asset reporting that appear to expand current foreign bank reporting standards to digital assets.[2] The U.S. uses the Foreign Account Tax Compliance Act, or FATCA, for foreign bank account reporting, but it does not currently include digital assets.

The OECD proposed a similar common reporting standard, or CRS, for foreign bank accounts, but it also doesn't cover digital assets. The CRS is arguably broader than FATCA; for example, no matter what amount of assets an individual or entity holds it must be reported to the proper tax authority and FATCA is only applicable after a threshold is met.

The OECD proposal for the addition of digital assets to its reporting scheme also appears to be seeking a broader definition of digital assets than currently being used in the U.S. However, the U.S.' new proposal does fix a known reciprocity limitation in FATCA for foreign bank accounts in its proposal for digital assets.

FATCA generally requires that foreign financial institutions and certain other nonfinancial foreign entities report on the foreign assets held by their U.S. account holders. The CRS was developed to obtain information from worldwide financial institutions and automatically exchange that information with other jurisdictions on an annual basis.

The overarching goal of both systems is to give a more transparent view of the financial assets held in foreign accounts. However, FATCA focuses only on U.S. taxpayers and CRS is designed to be global.

The U.S. came under criticism for not adopting the broader CRS standard, and FATCA itself creates a type of loophole where the same information foreign financial institutions must report to the U.S. is not reciprocally provided by U.S. financial institutions to foreign countries subject to FATCA.

As a consequence, news reports about leaked documents have exposed many financial transactions involving U.S. institutions by foreign nationals, which appear to be using the U.S. as a form of tax haven.

Because the cryptocurrency industry is entirely digital, it is easier for someone to engage in offshore transactions without ever leaving the U.S. Although the U.S. has a broad network of tax information exchange agreements with foreign countries, its recent revenue proposal acknowledges that these agreements only provide some information the U.S. requires under FATCA.

The U.S. recognizes that reporting obligations are not truly reciprocal and, in the world of digital assets, reciprocity is needed for any system to be effective. Therefore, the proposal requires U.S. financial institutions to report more information on foreign taxpayers with U.S. accounts, to encourage foreign countries to do the same.

Whether this means a more expansive FATCA, or adoption of the already broader CRS system, only time will tell. However, it appears clear that either choice will result in a more reciprocal agreement between U.S. and foreign financial institutions with regard to digital asset reporting.

This is important because, currently, a foreign country seeking information not automatically provided under FATCA must request that the U.S. seek information in its own courts using the John Doe summons process.

A John Doe summons, as the name implies, involves a group of taxpayers that the Internal Revenue Service cannot identify by name — yet. Judicial approval is required, but the approval is ex parte — i.e. opposing parties are not notified or can respond before the court rules.

Although the approval process involves a relatively low legal standard, primarily satisfied through affidavits of IRS officials, it is not automatic, and it can take substantial time to receive the documentation requested. Foreign countries have successfully used the U.S. courts, however, to get information on accounts held at U.S. banks by their own citizens.[3]

The John Doe summons is a favorite tool in IRS investigative efforts involving digital assets — as investigators wait for more expansive reporting laws. The IRS received 13,000 taxpayer names from Coinbase Global Inc. using a John Doe Summons. It also obtained permission to seek more names from two other cryptocurrency service providers, Circle Internet Financial Limited and Kraken Bank.[4]

Presumably foreign countries could also follow the same process to obtain information from U.S.-based institutions holding cryptocurrency assets. However, that process is unnecessary if a global standard can be implemented for the reporting of digital assets worldwide.

Worldwide Standards Beyond Reporting and Enforcement

Currently, there is no comprehensive regulatory standard for digital assets for taxation or otherwise. However, on June 30, the European Union agreed on significant regulations of blockchain technology as part of the Markets in Crypto-Assets Regulation, which would come into effect at the end of next year.

The speed of innovation and adoption of digital assets has consistently outpaced worldwide government regulation. The worldwide pandemic also slowed the ability of governments to develop and issue guidance and legislation on digital assets. The U.S. and the U.K. are still implementing their first proposals, but alleged agreement hasn't been reached.

For example, President Joe Biden issued a mandate in March for federal agencies to specifically develop plans for digital assets and even explore a potential digital version of the U.S. dollar.[5] In May, U.S. Sens. Cynthia Lummis, R-Wyo., and Kirsten Gillibrand, D-N.Y., introduced the Responsible Financial Innovation Act, or RFIA[6] as a first attempt at comprehensive regulation of digital assets.[7]

Other countries have already passed some laws related to digital assets and determining their effectiveness while some continue to try to ban them from their borders. Although, with an asset that is completely digital and decentralized, this attempt at banning cryptocurrency has proven to be mostly futile.

Regardless, all attempts at regulation throughout the world are being evaluated in an effort to develop a worldwide standard that can be applied to an asset that is located both everywhere and nowhere at the same time.

Legal, Illegal and Concerned Bystanders

In 2021, digital assets really moved out of the fringe shadows into the mainstream, forcing many countries to make decisions on how to handle the introduction into their economies. Governments, as discussed above, have an interest in taxing assets of value within their borders to fund the operation of the country.

Most countries, for efficiency purposes or otherwise, tried to merely put cryptocurrencies into existing taxation frameworks to avoid developing a set of unique rules and regulations. This was the approach in the U.S. when the Internal Revenue Service issued Notice 2014-21 saying that convertible cryptocurrencies were property and the rules applying to taxation of property applied.[8]

Some countries merely prohibit cryptocurrencies in their entirety to avoid needing to address the problem at all, while others do not outright prohibit cryptocurrencies but inform citizens to exercise caution because they are providing no protection for use of those assets.

For example, in South America seven countries allow cryptocurrency transactions including El Salvador, which accepted cryptocurrency as legal tender in 2021. Boliva and Columbia, however, have banned the use of cryptocurrency.

In Ecuador, citizens are cautioned regarding use of cryptocurrency, that it is not a means of payment authorized for use in the country and that financial transactions involving it are not backed, supervised or regulated by any entity in the country — i.e. proceed at your own risk.

If you look at other continents, the same varied approaches among countries are present.

The Future of Digital Asset Regulation and Taxation

The U.S. is home to the largest number of cryptocurrency investors, exchanges, trading platforms and cryptocurrency mining firms. However, it is not the first to pass legislation specifically regulating the taxation of cryptocurrencies.

In India, cryptocurrencies were originally banned by the Reserve Bank of India but are now allowed and subject to a recently introduced 30% flat tax on income from any cryptocurrency assets — i.e., cryptocurrencies and NFTs. India also has a 1% tax deduction in place at the source, for purposes of tracking cryptocurrency transactions as part of enforcement efforts.

Canada's treatment of cryptocurrency taxation is similar to that of the U.S., but individuals are taxed differently from businesses, in that individual taxable profits are cut in half so long as not part of an operating business.

Switzerland is making every effort to become one of the most digital asset-friendly countries in the world by creating a detailed licensing regime for cryptocurrency businesses. Although highly regulated, Switzerland has a cryptocurrency private-investor exemption that allows realized gains to avoid taxation if the terms of the exemption are met.

Following suit, the EU now has the makings of the first substantial regulation of digital assets, and the world is just waiting for the agreed text and the implementation date, reportedly in 2023 or 2024.

As many other countries are realizing there is substantial revenue to be gained in the digital asset market, a race to be first at making the rules is starting, and the EU is currently out front.

The U.S., although late to the party for enacting legislation, may still become the model to follow merely because of how much of the market would be affected by its new rules. The recently proposed RFIA at least starts the conversation in the U.S. and, possibly, the world on what comprehensive legislation would look like going forward.

The cryptocurrency industry has been relatively positive about the legislation, which could help it become law, as cryptocurrency companies have increased their lobbying efforts in favor of passage.

Taxation is covered in Title II of RFIA, and the first section addresses a common problem with mass adoption of cryptocurrency — the difficulty to use it to buy goods and services. The provision creates a de minimus exemption from gross income for dispositions of virtual currency in personal transactions. This amount will be both adjusted for inflation and subject to an aggregation rule to avoid abuse.

Another item in the proposed legislation is an amended definition of the term "broker" for digital assets, which was passed previously as part of the Infrastructure Investment and Jobs Act. The informational reporting associated with anyone determined to be a broker is set to start in 2023 but has been the subject of criticism for being too broad.

The current definition defines a broker as "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another."

The new definition would amend the definition to "any person who (for consideration) stands ready in the ordinary course of a trade or business to effect sales of digital assets at the direction of their customers." The law surrounding what constitutes a trade or business is well established and would presumably narrow those required to submit informational reporting.

One of the most interesting parts of the new legislation is that it contains a list of guidance that the IRS must produce, including the classification of income from forks, airdrops and similar subsidiary value that appears to overturn previous IRS guidance.[9]

The proposed legislation also creates a specific subsection deferring income relating to proof of stake-mining rewards that are becoming a popular mining mechanism for newer blockchains. This also directly contradicts current IRS guidance that makes such mining rewards taxable on receipt and control.

This same issue is currently involved in Jarrett v. U.S., a suit pending in the U.S. District Court for the Middle District of Tennessee between taxpayers and the U.S. Department of Justice Tax Division.[10]

It is impossible to know what, if any, of these provisions might actually become law. However, this first step is important in fostering conversations on a regulatory environment so the U.S. is not left behind.

Conclusion

Although many provisions discussed above are proposals, or rules may change over time, a standard will eventually emerge. Why? Because it needs to emerge for widespread adoption and continued growth of digital assets.

Why do digital assets need to grow? Because the number of interested investors, companies and governments involved worldwide is now so large that a uniform solution is no longer a noble concept but a necessity.

The world has recognized the usefulness of cryptocurrencies, NFTs and the underlying blockchain technology. Although a little behind, governments will eventually catch up and determine exactly how best to use and tax the value of digital assets.

As these rules develop, individuals, companies and their advisers will need to watch and advocate for rules that balance the need for fair taxation with quality use, adoption and innovation.

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[1] Compania General de Tabacos v. Collector of Internal Revenue, 275 U.S. 87 (1927)(J. Holmes dissenting).

[2] General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf; OECD Crypto-Asset Reporting Framework and Amendments to the Common Reporting Standard, https://www.oecd.org/tax/exchange-of-tax-information/public-consultation-document-crypto-asset-reporting-framework-and-amendments-to-the-common-reporting-standard.pdf.

[3] See https://www.justice.gov/opa/pr/federal-courts-authorize-service-john-doe-summonses-seeking-identities-persons-using-payment.

[4] See https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1.

[5] https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/.

[6] The Responsible Financial Innovation Act, https://www.gillibrand.senate.gov/imo/media/doc/Lummis-Gillibrand%20Responsible%20Financial%20Innovation%20Act%20%5bFinal%5d.pdf.

[7] https://www.gillibrand.senate.gov/imo/media/doc/Lummis-Gillibrand%20Responsible%20Financial%20Innovation%20Act%20%5bFinal%5d.pdf.

[8] See IRS Notice 2014-21.

[9] See Revenue Ruling 2019-24.

[10] Jarrett v. U.S., Civil No. 3:21-cv-00419 (M.D. Tenn.).