

# The Cryptocurrency Law And Policy Outlook For 2023

By **Joshua Smeltzer** (January 3, 2023)

Digital assets have experienced a bumpy ride over the last two years.

In 2021, we saw the adoption rate and value of digital assets skyrocket. Then, in 2022, the value of those same digital assets and the NFT market fell precipitously, followed by the bankruptcy and demise of several large digital asset companies as the first breezes of crypto winter began to blow.

Spectators who had never entered the digital asset space pointed fingers and said, "I told you so." Many true believers stayed the course and even increased their digital asset holdings believing the value would rise again.



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However, even the truest of believers are now reevaluating what the future of digital assets and blockchain will look like. The chaos of 2022 created a lot of cynicism — but those feelings may be more aptly labeled as confusion.

As we enter a new year, with hopes of digital asset recovery, we should consider several things about how the industry will change over the coming year.

## **Trust is a digital asset company's biggest priority.**

Digital assets proposed a peer-to-peer financial system that was trustless. The implementation of that system, however, required more trust than many individuals, companies and policymakers anticipated.

Those who interact with digital assets, especially new adopters, do not directly use the underlying blockchain technology. Instead, they rely on a variety of mostly unregulated intermediaries. While blockchain technology is trustless, intermediaries that interact with the blockchain on behalf of others create a need for trust that can, and has been, abused.

Many digital asset users and investors do not have the time to acquire the requisite technological skill to interact directly with the blockchain technology. Therefore, this year there will be a premium on companies that develop procedures and implement safeguards to allay fears and encourage continued growth in the space.

The companies that will survive are those willing and able to provide a trusted system while still leveraging the decentralized nature of the technology and its associated digital assets.

Recent company failures can be blamed on poor management and, in some cases, outright fraud. But there are solutions to protect the integrity of the industry, and the consumers and investors participating.

It can be expected that the first proposals, introduced at the end of 2022, will be discussed and potentially implemented this year. These include proof of reserves — i.e., proof that a company has sufficient assets to cover its liabilities at any given time — and other consumer protections using blockchain technology or some other public verification of on-chain assets or third-party audit results.

Customers may also demand self-custody — i.e., noncustodial — of their wallets to keep a

more direct store of their private keys. There will be inevitable tradeoffs in privacy, anonymity and convenience, but those will be balanced against a more trusted system that encourages broader participation.

Years ago, a similar scenario played out for internet companies during in the so-called dot-com bubble. The internet created new technology that fueled wild speculation, followed by the public failure of several large internet companies — e.g., Pets.com, eToys, etc.

This did not result in the end of the internet, just in more cautious consumers and investors. Many companies failed, and significant capital was lost, but some of the largest technology companies emerged out of that chaos — Amazon.com Inc., eBay Inc., etc.

Self-imposed protections will help reinstitute trust in the digital asset space. However, policymakers will not be satisfied with the industry governing itself, especially given the recent company failures.

### **More government regulation is inevitable and necessary.**

Governments mostly ignored digital assets since their creation in 2008, until widespread adoption started in 2021. The digital asset community, until recently, mostly expressed antagonism toward regulators, and regulators themselves expressed antagonism toward the digital asset industry.

However, many within the digital asset community appear to acknowledge that some form of regulation would be a good thing. The ethos of digital assets is still focused on operating outside government control — but operating outside some form of government oversight hasn't had great results.

Prior to 2021, governmental involvement in the digital asset space primarily involved the Internal Revenue Service, which focused merely on locating all the digital assets so that they could be taxed. The IRS issued letters and notices threatening taxpayers about not reporting and paying taxes on their digital assets, but actual guidance was very limited.

Official guidance on the taxation of digital assets didn't really occur until 2014, and then not again until 2019, despite increased adoption and technological advancement. Even unofficial guidance in the form of chief counsel advice memoranda and private letter rulings, which cannot be cited as authority, was limited.

Instead, the IRS continued to march forward on its hunt for hidden treasure by issuing John Doe summonses to various exchanges — Coinbase, Kraken, Circle, sFox, etc. — for names and transactions that couldn't otherwise be obtained through analytics. There were no mandatory information reporting requirements — yet.

The IRS and other agencies like the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission, have been focused on fitting digital assets into the frameworks they already have.

In some situations, digital assets could fit comfortably into the existing rules. However, increasingly, the unique aspects of borderless digital assets fall outside historic tax and securities principles, laws and regulations.

The only real legislative change in the treatment of digital assets was in 2021's Infrastructure Investment and Jobs Act, which extended tax information reporting

requirements to digital asset "brokers." However, the new reporting rules, again, merely focused on making sure that the transactions and the people transacting were known for tax purposes.

The industry has expressed concern over the broad scope of the act's broker definition. However, clarifying regulations that were expected in 2022 never arrived, and on Dec. 23, 2022, the IRS postponed any reporting requirements until final regulations are provided.[1]

The proposed regulations and the industry's ability to comment have been pushed to this year, and most likely will be among several new legislative or regulatory rules addressing the current needs and concerns.

The IRS has substantial new funding, and digital asset guidance is long overdue. The recent industry failures will likely prompt the completion, finally, of several digital asset guidance projects languishing on the desks of IRS officials.

As new rules are provided, the industry, individuals, trade groups and others should prepare to participate in the notice and comment process and attend hearings, to provide a thoughtful approach rather than a knee-jerk reaction to some bad actors.

In the tax context, additional guidance is not just something that is nice to have; it is necessary for tax advisers to be able to provide proper advice to their clients.

Understanding the tax treatment of financial transactions, even when the assets and the transactions are well known, often requires knowledge and nuanced interpretation of multi-faceted Internal Revenue Code provisions. When you add an unknown and unique asset class, the analytical problems are exacerbated.

For example, the concept of deferring taxable gains by exchanging like-kind assets is a well-known tax principle that has been applied in various forms since the 1920s. In 2018, like-kind exchanges were limited to real-property.

Prior to 2018, the only official IRS guidance on digital assets was Notice 2014-21, which indicated that cryptocurrencies were considered property and that tax principles associated with property applied.[2]

Analytically, it appeared that prior to 2018 like-kind exchanges of cryptocurrencies — i.e., taxable property — could be deferred through the like-kind-exchange process. However, in 2021, the IRS released a chief counsel advice memorandum stating that some of the most popular cryptocurrencies — bitcoin, ether and litecoin — were not considered like-kind.[3]

As digital assets, the companies that use them and the technology itself evolve, many more tax questions are being raised, but the guidance isn't keeping pace. For example, no guidance has been issued on the tax treatment of non-fungible tokens.

This lack of specific guidance is untenable and needs to change.

### **Courts will decide legal issues involving digital assets this year.**

Lawsuits involving digital assets have been limited and sporadic. However, many legal issues involving digital assets have finally made their way to the courts.

Most notably are the bankruptcy proceedings of Voyager Digital Holdings Inc., Celsius

Network LLC and FTX Trading Ltd. Many other smaller digital asset companies have also found themselves in need of bankruptcy protections.

These cases are important for the digital asset industry because some real questions about the characterization of the digital assets involved — e.g., security or commodity? — will likely need to be decided in order to administer the bankruptcy estate.

Also, the nature of the property and how it should be treated for bankruptcy purposes could provide guidance for other areas, like taxation, where digital assets are involved.

Other lawsuits, like Grayscale Investments LLC's suit against the SEC for the denial of their application for a digital asset exchange traded fund, currently pending in the U.S. Court of Appeals for the District of Columbia Circuit, and digital asset valuation questions in the U.S. Tax Court, will also start answering questions on legal definitions and issues that policymakers and regulators have been unwilling or unable to answer.

The courts may not be the best place to resolve these legal questions, but many of these cases will likely require resolution this year, and certain legal questions must be answered in the process.

### **Recovery will start this year and may be driven by traditional finance.**

This is a bold prediction given the seemingly endless crypto winter of 2022 and continued problems that seem to hurt actual recovery.

In 2022, the cracks in the current digital asset industry were exposed, but exposure allows the industry to determine solutions that can be proposed to policymakers and regulators charged with protecting consumers and investors. Remarkably, traditional finance may provide a good guide for the recovery of the digital asset industry.

Traditional finance has, until recently, stayed away from the digital asset space, probably because of doubts about digital asset viability or concerns over inserting a speculative and volatile asset into a highly regulated banking system. However, in 2022 the traditional banking and finance industry started to accept digital assets.

The Coinbase exchange became a publicly traded company — subjecting it to normal disclosure and other requirements of public companies — and then teamed up with the world's largest traditional asset manager, BlackRock Inc.

Fidelity Investments, the largest 401(k) administrator, began offering a bitcoin fund to workers in 2022 as well, despite warnings from the U.S. Department of Labor on its volatility.

JPMorgan Chase & Co., Morgan Stanley and Goldman Sachs all have dedicated groups within their firms for cryptocurrency and blockchain technology. Although there will still be startup companies that flourish in the digital asset space, the presence of blue-chip financial firms will help with both credibility and recovery of a battered industry.

Potentially more important is that traditional finance has navigated multiple financial downturns, recoveries, bubbles and other potential disasters, and done it all in a highly regulated and competitive environment.

Traditional financial firms are also very familiar with the taxation of a variety of regular and

more exotic financial assets, and can provide guidance to regulators on how new assets might fit into systems already tested.

This year, hopefully we will see more partnerships between digital asset companies and traditional finance companies that are mutually beneficial to the companies involved, that benefit the industry in general and that encourage the development of the blockchain technology.

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[1] <https://www.irs.gov/newsroom/treasury-irs-provide-transitional-guidance-for-broker-reporting-on-digital-assets>.

[2] IRS Notice 2014-21.

[3] See CCA 202114020.