NEWS ANALYSIS

Watch Out Crypto Exchanges and Hodlers!

by Lee A. Sheppard

Your correspondent is not running for U.S. Senate in Ohio.

We had to clarify that because seemingly every other middle-aged adult born in Ohio is running for the Senate seat being vacated by Sen. Rob Portman, R-Ohio, the lead negotiator on the infrastructure bill, H.R. 3684, the Infrastructure Investment and Jobs Act, and the father of the controversial cryptoasset reporting provision. The bill passed the Senate 69 to 30 on August 10.

One of those candidates, venture capitalist and author of *Hillbilly Elegy* J.D. Vance, weighed in on that reporting provision. "Not only would this lead to mass surveillance of those in the cryptocurrency community, experts in the field warn that it could amount to a backdoor ban of Bitcoin and other popular cryptocurrencies," he said. Why is Vance bad-mouthing opportunistic revenue-raising by his establishment predecessor? He and others have noticed that the crypto crowd are libertarians. So they want to get on their good side.

Readers who do not have corporate clients concerned about becoming brokers subject to reporting requirements may represent rich individuals who are the ultimate object of those requirements. Cryptocurrency was on the way to becoming the new Swiss bank account. Some clients are speculating in cryptoassets, while others may be trying to hide funds from creditors, children, and ex-spouses. Rich people don't want their children to know how much they have.

Bitcoin is a tax on gullibility. It is deflationary. It is priced inversely to gold. Like reverse repos, cryptocurrencies take excess money out of circulation. SEC Chair Gary Gensler referred to cryptocurrencies as "highly speculative stores of value." But the rich can't all be that gullible! My clients are self-made! The rich can be shockingly gullible; they give each other investment advice on the golf course. They love the idea of liquidity the same as the middle class loves luxury and millennials love locally grown.

That's why hopeful cryptoasset holders are cynically referred to, often among themselves, as hodlers. There's even a PAC for them called HodlerPAC. Indeed, if *Washington Post* headlines are an indication, cryptoassets are more powerful as a political force than they are as an asset class. There is nearly $2 trillion parked in more than 11,000 cryptocurrencies. While much is held by institutional investors, like hedge funds, whose algorithms buy the dips, smaller investors drive growth. The big financial players are planning cryptoasset exchange-traded funds, and the SEC has been sitting on applications for them. Circle K plans to install bitcoin ATMs.

So in addition to the latest crypto legal developments, we review a new book for those readers who represent — or are about to find out they represent — cryptoasset hodlers. The book functions as a useful primer on the laws of many countries that are applicable to cryptoassets. Generally, the developed countries where your clients actually reside and made their fortunes do not have specific tax rules for cryptoassets. And yes, many rich people have foreign spouses or may be taxable in more than one jurisdiction (Schmidt et al., *Taxation of Crypto Assets* (2021)).

Tax Reporting

The broad, original version of the tax reporting proposal went in the Senate-passed version of the infrastructure bill.

The infrastructure bill would require Form 1099 transaction reporting by crypto brokers, complete with basis reporting (section 6045). The bill would treat digital assets as specified securities for this purpose. Digital asset would be defined as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology." Reportable transactions would be expansive. Broker would be broadly defined (discussed

But will there be a KISS cryptocurrency? (APEX/MEGA/Newscom)

below). Separately, digital assets would be treated as cash for the general currency transaction reporting requirement, the threshold for which is $10,000 (proposed section 6050I(d)(3)).

Sen. Ted Cruz, R-Texas, offered an amendment to delete the entire reporting provision. "The Senate's going to inflict billions of dollars of damage on the growing and exciting crypto industry & drive much of it overseas. There aren't 5 Senators who understand much of anything about crypto," Cruz tweeted.

Cruz's amendment didn't stand a chance. Two competing amendments to narrow the reach of reporting were offered by Senate Finance Committee Chair Ron Wyden, D-Ore., and Portman, the latter enjoying Treasury endorsement. Some proponents of these amendments later compromised on a single narrowing amendment that would require unanimous consent of the Senate for inclusion in the legislation. Wyden did not join the compromise amendment, but Treasury Secretary Janet Yellen endorsed it. (Prior coverage: *Tax Notes Federal*, Aug. 9, 2021, p. 879.)

"We came together to provide greater clarity on who are the actual brokers of a cryptocurrency. We're not proposing anything sweeping or anything radical," Sen. Patrick J. Toomey, R-Pa., said. "While we each would have drafted this solution differently, we all agree it's important to ensure that these obligations are properly crafted to apply only to entities that are regularly effectuating transactions of digital assets in exchange for consideration," Portman, Toomey, Sen. Kyrsten Sinema, D-Ariz., Sen. Mark R. Warner, D-Va., and Sen. Cynthia Lummis, R-Wyo., said in a statement.

Broker would still be broadly defined as "any person who (for consideration) regularly effectuates transfers of digital assets on behalf of another person" (proposed section 6045(e)(1)(D)). The compromise amendment would exclude miners and stakers "validating distributed ledger transactions, without providing other functions or services," as well as wallet developers "selling hardware or software for which the sole function is to permit persons to control private keys which are used for accessing digital assets on a distributed ledger."

"I don't believe the cryptocurrency amendment language on offer is good enough to protect privacy and security, but it's certainly better than the underlying bill," Wyden tweeted about the compromise.

> ***The broad, original version of the tax reporting proposal went in the Senate-passed version of the infrastructure bill.***

It was a hard-fought battle over amendments to the Portman provision in the infrastructure bill. Big names like Jack Dorsey, Elon Musk, and Andrew Yang weighed in, arguing that the provision could kill the industry. Yellen lobbied for reporting with exemption only for miners and stakers. Even Gene Simmons took a side. Celebrities are rushing to create non-fungible tokens to monetize their images. A lot of lobbying took place on Twitter, where the special handle #DontKillCrypto was launched, resulting in senators' offices being bombarded with phone calls.

Toomey went to the floor with the compromise amendment, and retiring Sen. Richard C. Shelby, R-Ala., objected. That was enough to keep it out of the bill. Shelby was irritated because he didn't get a chance to offer his amendment to increase military spending. That means that the crypto crowd has to start over again in the House. Rep. Tom Emmer, R-Minn., of the Congressional Blockchain Caucus sent a letter to his fellow House members outlining technical problems, emphasizing that noncustodial participants have no way to collect customer information.

"We will continue to look for ways to fix the digital asset language in this bill. It might not be today, but we won't give up," Lummis tweeted. The House reconvenes August 23. (Related coverage: p. 1143.)

Proposed Crypto Legislation

We were not kidding about the whole-of-government project.

Those crypto types who regarded Gensler's remarks as a declaration of war might be more disturbed by a concrete bill, H.R. 4741, the Digital Asset Market Structure and Investor Protection Act, offered by Joint Economic Committee Chair Donald S. Beyer Jr., D-Va. Treasury would be granted the power to regulate and veto the creation of stablecoins. Regulators would be authorized to make rules for decentralized finance and register crypto exchanges, which would be subject to extensive information reporting. The bill would treat some cryptoassets as securities, with commodities treatment as a residual category. Exchanges would have to report transactions. (This bill will be discussed in a forthcoming article.)

Even the IRS would be involved. The Beyer bill would ask the IRS to estimate the number and proportion of U.S. citizens who own digital assets relative to those who own conventional securities, as well as relative failure to report income from different assets, plus the amount of lost tax revenue. The IRS would be asked to estimate the number of U.S. citizens on domestic and foreign crypto platforms — Coinbase has 60 million accounts. Essentially this would be a report making the case for the Form 1099 reporting in the infrastructure bill. The Justice Department would be tasked to report on ransomware.

> ***Those crypto types who regarded Gensler's remarks as a declaration of war might be more disturbed by a concrete bill offered by Beyer.***

There's definitely a political angle here. While the Trump administration took a tolerant attitude toward crypto operations, the Biden administration wants to corral them, track transactions, and institute a system of permissions. The Trump OCC allowed its charges — federally chartered banks and savings institutions — to make blockchain networks part of their business. As of January 2021, the OCC currently permits banks to use stablecoin for payment services, participate in blockchain verification networks, and serve as independent nodes (OCC Interpretive Letter 1174 (Jan. 4, 2021)). But the Beyer bill would give Treasury veto power over stablecoins.

Few jurisdictions have adopted cryptoasset financial regulation. New York, Wyoming, the Cayman Islands, Gibraltar, Malta, Mexico, Liechtenstein, Luxembourg, the United Kingdom, and Germany have financial regulation. Yes, readers, the European tax havens are the first movers.

India might be on the verge of banning cryptocurrencies, following China's ban on mining. At the moment, Indians can trade cryptocurrencies on exchanges, but the country has capital controls. In 2019 an intergovernmental committee suggested an outright ban, with criminal punishments, but furious lobbying seems to have pushed the government toward regulation. The Ministry of Corporate Affairs told companies to report cryptoassets on their books, which observers see as a sign of acceptance. Lawyers argue that a ban would be unconstitutional, after a 2020 Supreme Court decision that a Reserve Bank ban on virtual currency transactions violated fundamental rights of the exchanges (*Internet and Mobile Association of India v. Reserve Bank of India*, Nos. 373 and 528 (Mar. 4, 2020)).

The Reserve Bank of India has quite a bit of power in this regard. In 2013 it warned retail investors off cryptocurrencies. In 2018 it prohibited financial intermediaries from dealing in virtual currencies or providing services to any entity that did. That ban was reversed by the Supreme Court case. The Court said the ban was not rationally related to the professed purpose and was disproportionate to the perceived money laundering threat. The government is preparing new legislation, while a bill for an outright ban is still floating around, according to Aseem Chawla of ASC Legal. Ironically, in any regulated scheme, the Reserve Bank would be the regulator.

Russia doesn't want its citizens using cryptocurrency but accepts the existence of other cryptoassets. Under a law that went into effect in January, Russian companies, branches, and individual residents may not receive payments in cryptocurrency (Law N 259-FZ). Cryptocurrency claims are enforceable only if ownership and transactions are declared. Russian law treats cryptocurrency as an asset and a means of payment but not money, while crypto rights, like tokens, are treated as intangibles, according to Daria Romanova of AT Lawyers, writing in *Taxation of Crypto Assets*.

Foreign Hodlers

Very few countries have specialized tax laws for cryptoassets.

Although parts of it might be out of date by the time the infrastructure bill is passed, and developments proceed apace in other countries, *Taxation of Crypto Assets* is well organized and answers your basic questions for 39 countries. Most of the contributors are lawyers, who use a fair amount of idiosyncratic national tax jargon. The chapters do address the inevitable question of substantiation of loss of a private key. The editors seem to be cheerleaders for these products. Yes, lawyers are humanly capable of drafting bad contractual language, but does anyone really want to be bound by a mutating contract created by computer programmers?

Do other countries have special cryptoasset laws? Surprisingly they do. The United States is not at the forefront. Although tax havens, where few holders actually reside, were the first movers on crypto financial regulation, none has a special tax regime for cryptoassets. Poland and South Africa have some actual laws, which have interesting commonalities. Argentina incorporated cryptoassets in its income tax law. Malta, Russia, South Korea, and the United Kingdom have administrative guidance. Nonetheless, several countries without specific rules, including Canada, Japan, and France, are actively auditing.

Very few countries have specialized tax laws for cryptoassets.

Polish corporate and personal income tax law has been amended to address convertible cryptocurrencies, which are defined according to anti-money-laundering rules. For holders, cryptocurrency is a capital asset, gains on which are taxable at a 19 percent rate. Cryptocurrency losses cannot be used against other capital gains or other income. For holders, cryptocurrency-to-cryptocurrency transactions are tax neutral. Crypto exchanges must treat crypto gains and losses, as well as cryptocurrency-to-cryptocurrency transactions, as business income and loss. Salary paid in cryptocurrency or other cryptoassets is taxable and subject to withholding. Administrative rulings on mining say that mined cryptocurrency is not taxable until disposition. Advisers will have to figure out the treatment of other cryptoassets for themselves, according to Joanna Prokurat of Wardynski & Partners.

South Africa made changes to both income tax and value added tax laws to accommodate cryptocurrencies, which are not treated as money but are financial instruments. Both cryptocurrency and cryptoassets are property. Holder gains are capital, and dealer or business gains are ordinary. Individual holder losses are ring-fenced for use only against crypto gains. Crypto-to-crypto transactions are barter, but the gain could be capital or ordinary, depending on the participant's tax posture. Receipt of cryptocurrency for goods and services is barter, and the disposition of the cryptocurrency is a separately taxable event. Treasury wants the statutes broadened to cover other cryptoassets, according to Emil Brincker, Louis Botha, and Louise Kotze of Cliffe Dekker Hofmeyr.

South Africa has comprehensive tax rules for mining. A miner is usually treated as engaged in a trade or business under South African law. The receipt of cryptocurrency from mining or staking is income in the amount of the fair market value of the cryptocurrency. Cryptocurrency obtained by mining becomes inventory for the miner, and ordinary income results from disposition, but basis and expenses can offset it. The treatment of staking is less clear because a validator retains an annual incentive payment in cryptocurrency, but also puts up (stakes) long-held cryptocurrency as collateral. Crypto losses are ring-fenced for use against other crypto income. An unincorporated pool of miners would be treated as a partnership.

There is no definition of "digital currency" used in the 2017 Argentine tax reform changes, aimed mainly at individuals holding crypto investments (law No. 27430). Other Argentine financial regulatory agencies each use a different term. Leandro Passarella of Passarella Abogados explained that digital currencies are believed to encompass all types of cryptoassets other than securities, to ensure maximum flexibility for the tax administrator. The new law treats cryptoassets as intangibles, which are taxed as debt securities. Any transfer is treated as a sale, and first-in, first-out determines which coins were sold. A miner may be treated as an issuer. Cryptoassets created in Argentina produce domestic-source income, and foreign-created cryptoassets have foreign source.

But what about the HM Revenue & Customs guidance in Blighty? In two nonbinding policy papers, HMRC said that cryptocurrencies are property and not money. Cryptoassets attract stamp duty if they are securities. Cryptocurrencies do not create loan relationships because there is no counterparty. But cryptocurrency held by a business is not automatically a trade (business) asset, according to Benjamin Fryer and Bridget English of Gibson, Dunn & Crutcher LLP. HM Treasury is conducting a consultation on money laundering.

HMRC's internal Cryptoassets Manual deals extensively with the problems faced by businesses with cryptocurrencies (CRYPTO40000). A business buying and selling cryptocurrency is engaged in a financial trade only if that activity reaches a very high level of frequency and sophistication (CRYPTO40150). Casual mining or staking does not rise to the level of a trade, so awarded cryptocurrency creates miscellaneous income of FMV of the coins, which are a capital asset with that basis. Miners and validaters engaged in a trade have gross receipts for awarded cryptocurrency, which presumably becomes inventory (CRYPTO40200, CRYPTO40250).

Just in time for this article, HMRC put out guidance on individual valuation of cryptoassets in a new addition to the internal Cryptoassets Manual (CRYPTO23000). Seems exchange-traded cryptoassets aren't being priced in sterling, which hasn't been the reserve currency for nearly a century. So British hodlers have to find an appropriate exchange rate to convert the prices and use a consistent valuation method. The advice is the same for a business holder, and HMRC makes clear that a cryptocurrency-to-cryptocurrency transaction would be taxable (CRYPTO40100).

Compliance

Cryptoasset transactions are not the occasion for aggressive tax return positions.

At a recent Stafford webinar on NFTs, Jonathan Kalinski of Hochman Salkin Toscher Perez PC advised practitioners to be cautious in their positions. Just because there is no law on a new cryptoasset question doesn't mean that the IRS can't argue that "you should have known better" down the road. Crypto audits are ramping up, but we are still in early stages.

"The place you want to be is to be safe and to be cautious when you're reporting," said Kalinski. A purchase of a cryptoasset using another cryptoasset is taxable as barter. Taxpayers have to keep records; the blockchain won't do it for them. On audit, the taxpayer can't shrug his shoulders and say it was on the blockchain. "Relying on the exchange is going to get you into trouble," he said. "Recordkeeping is of the utmost importance."

Kalinski foresaw use of cryptocurrency for charitable contributions, which would be contributions of property at FMV. Some cryptoassets and NFTs can be valued based on comparable assets. But taxpayers shouldn't be aggressive because values can be verified eventually. "Old-world rules are not always a perfect fit for new-world technology, but taxpayers should use best practices," he said.

"If they're not your keys, they're not your coins" is a crypto saying. A hosted wallet, like Coinbase or Kraken, can lock a customer out of his account if it thinks there is something fishy going on. At the moment, these exchanges can't calculate basis for customers; they have been using Form 1009-K, showing gross transactions. MetaMask is the most popular unhosted wallet; it's just software, and its founders take the position that users are not customers. Trezor is a hard wallet. How does the IRS find out? Crypto enthusiasts have a habit of confirming their transactions on Twitter, according to Jordan Bass of Taxing Cryptocurrency, who spoke at the webinar.

> ***'The place you want to be is to be safe and to be cautious when you're reporting,' said Kalinski.***

"The people who are coming to me are the people who by and large want to get things right," said Bass. "There are people out there who want to remain anonymous and don't want to pay taxes." The latter group are not persuadable. But the IRS has a lot of tools to track them, as the letters sent to crypto holders demonstrated. "If you received one of these letters, and you chose to ignore it, that was not smart," said Bass, warning of fraud penalties. He analogized IRS pursuit of holders of foreign bank accounts. "How'd that work out?" he asked rhetorically.

"Recordkeeping is the key," said Kalinski. A crypto wallet doesn't have to be reported on an FBAR, generally, but it depends on whether the custodian is a foreign financial institution, in which case it should be reported on Form 8938. For example, if a U.S. resident individual had a Binance account, that arguably should be reported on Form 8938.

Is the client dabbling in derivatives on Binance? The world's largest crypto exchange is very popular but is in hot water with regulators all over the world. The IRS, the CFTC, and the Justice Department bank integrity unit are investigating Binance, which now blocks U.S. and U.K. residents by order of financial regulators. Cayman, Japanese, and European financial regulators have also expressed their displeasure. Thailand's securities regulator filed criminal charges. The CEO of Binance's U.S. affiliate — a former head of the OCC — just quit. Binance hired former Finance Committee Chair Max Baucus to help it with government relations.

Bass, who prepares returns, uses a computer program to reconcile the exchange blockchain reporting using the taxpayer's application program interface (API) key with the basis information required for returns. If the taxpayer is on an unhosted wallet, Bass will pull all the data using the taxpayer's API key and devise a cost basis based on the spot price on the date of the transaction.

An API is a software tool that allows a customer to communicate with the exchange, similarly to the way tax software retrieves data from the taxpayer's broker. An API has double key entry, like bitcoin. And yes, there is crypto tax API, like the product CryptoTrader.Tax. The level of access an API grants is variable. It can be read-only, for gleaning transaction information, as with tax API. Or it can allow the customer to access funds and trade the account. Some customers have crypto trading bot APIs that automatically execute trades according to a programmed trading strategy.

Trouble is, the taxpayer may not have access to all of his data, either because it is old or the exchange may be defunct. The data the taxpayer provides cannot be assumed to be complete, especially before 2018, Bass cautioned.

"When in doubt, disclose," said Bass, recommending Form 8275 for transactions for which there is no guidance. "It's those who are hiding who are ultimately going to receive the harsh treatment." The IRS favors coming clean in these situations.

But the government is going to hunt down the client's cryptocurrency! Don't worry. K2 will find it before the government does, while working for your client's ex-spouse. A solid prenup would serve the client better than all the tax planning in the world. ■