The Banking Law Journal

Established 1889

An A.S. Pratt™ PUBLICATION OCTOBER 2022

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THE BANKING LAW JOURNAL

VOLUME 139 **NUMBER 9** **October 2022**

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ISBN: 978-0-7698-7878-2 (print)
ISSN: 0005-5506 (Print)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

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(2022–Pub.4815)

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Responsible Financial Innovation Act: Proposed Tax and Reporting For Digital Assets

By Andrea S. Kramer, John T. Lutz, William R. Pomierski and Andrew M. Granek*

This article discusses key tax considerations raised by the Responsible Financial Innovation Act, concerning taxation and reporting requirements for participants in the digital asset industry.

Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) have introduced the highly anticipated Responsible Financial Innovation Act (the "bill"), which sets out to create the first complete regulatory and bipartisan framework for digital assets. The bill is intended to establish some legal clarity for regulators and the industry and to protect consumers by providing a range of disclosures and clarifying settlement conditions and rights over digital ownership. The bill would also treat all digital assets that are not treated as securities as commodities regulated by the Commodity Futures Trading Commission. This article discusses key tax considerations raised by the bill concerning taxation and reporting requirements for participants in the digital asset industry.

IRS GUIDANCE AND DE MINIMIS EXCLUSION

The bill requires that the Internal Revenue Service ("IRS") adopt guidance or clarify important issues involving digital assets, including mining and staking activities. Currently, the only government guidance on virtual currency mining is IRS Notice 2014-12,[1] which does not have the force of law and may be disregarded by courts. In Notice 2014-12, the IRS asserts that by performing "Proof of Work" validation services, the fees that miners receive in virtual currency units are ordinary income and taxable at the fair market value as of the date they receive the units. The government has been silent on the tax treatment

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[1] 2014-16 I.R.B. 938, Q&A-8, 9.

of staking activities that support blockchain networks or verify payments. The bill allows cryptocurrency miners and stakers to defer taxes with respect to such activities until those assets are disposed of.

The bill also instructs the IRS to issue guidance that:

- Classifies forks, airdrops and similar transactions that qualify as "subsidiary value" taxable events contingent upon the claim and disposition of the "subsidiary value" by the taxpayers;
- Implements the broker reporting and cash reporting rules enacted by the Infrastructure Investment and Jobs Act (HR 3684);
- Allows for charitable contributions greater than $5,000 without the need for a qualified appraisal; and
- Characterizes stablecoins as debt.

The bill does not, however, clarify what a "subsidiary value" is. The bill also exempts from taxation up to $200 of gains or losses from the disposition of virtual currencies in personal transactions and treats a series of "related transactions" as part of the same transaction for purposes of this exemption but does not provide further clarity on what constitutes a related transaction.

BROKER CLARIFICATION

The bill clarifies that the term "broker," as used in HR 3684, excludes miners and stakers as well as wallet providers and developers, thereby relieving them from certain IRS reporting requirements.

Under current law, those who are involved in mining, staking or providing digital asset hardware or software wallets may fall under the definition of "broker" for tax purposes and be subject to reporting requirements. Internal Revenue Code ("IRC") Section 6045 generally imposes reporting requirements on "every person doing business as a broker" with respect to sales affected by the broker on behalf of its clients, where "broker" is defined to include a "dealer, a barter exchange, and any other person who (for consideration) regularly acts as a middleman with respect to property or services" and "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."

The bill defines a "broker" as any person who stands ready in the ordinary course of a trade or business to effect sales of digital assets to customers for consideration, which likely indicates that miners, wallet providers and software developers will not fall under this definition. This definition also relieves them of reporting requirements imposed by current law.

LENDING AGREEMENTS AND TRADING SAFE HARBORS

The bill assures that digital asset lending agreements would be taxed along the lines of existing rules for securities loans, where gain or loss is not realized in the exchange—if certain conditions are met—by expanding the definition of "securities" to include digital assets (solely for U.S. federal income tax purposes related to lending transactions).

The bill also extends the current trading safe harbors under IRC Section 864(b)(2), which currently covers securities and commodities trading activity made by non-U.S. persons, to include trading digital assets through a U.S. broker, custodian, commission agent, digital asset exchange or other independent agent without the risk of being treated as engaging in a US trade or business.

Additionally, trading in digital assets for a non-U.S. person's own account, whether by the taxpayer, the taxpayer's employees or through an agent, would not be treated as engaging in U.S. trade or business, provided the taxpayer is not a dealer in digital assets. Notwithstanding the above, the safe harbor does not apply if the non-U.S. person has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in digital assets are affected.

DECENTRALIZED AUTONOMOUS ORGANIZATIONS

The bill declares that certain incorporated decentralized autonomous organizations ("DAOs") are, by default, business entities for tax purposes by including them under IRC Section 7701. It defines a DAO as an organization that utilizes smart contracts to conduct business, commercial or charitable activities which is governed primarily on a distributed basis and is incorporated or organized under the laws of a state or foreign jurisdiction. By classifying DAOs as business entities, the bill seeks to tax them as a corporation or partnership for U.S. federal income tax purposes and provides them with tax benefits that are generally unavailable to unincorporated associations.

RETIREMENT ACCOUNTS

The bill requires the U.S. Government Accountability Office ("GAO") to explore the potential opportunities and risks associated with retirement investing in digital assets and to report to U.S. Congress, the U.S. Department of the Treasury and the U.S. Department of Labor. More specifically, it instructs the GAO to investigate potential benefits to the diversification and return of an

investor's retirement portfolio, appropriate asset allocations, digital asset consumer education and financial literacy, risks and barriers to effective retirement investing in digital assets.

CONCLUSION

While generally viewed as "friendly" legislation to the digital asset industry, the bill attempts to strike a balance between responsible innovation and consumer and investor protection. It also sets out to create the first digital asset regulatory framework for the industry by providing a framework for the integration of digital assets into existing U.S. tax laws. Time will tell if any (or all of) these provisions are ultimately enacted into law.