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Senate Finance Committee Requests Public Comments on Digital Asset Taxation

Tax Talks on **August 30, 2023**

On July 11, 2023, the Senate Finance Committee released an open letter to the Digital Asset Community asking a variety of questions in connection with possible future legislation. Public comments must be emailed to the Senate Finance Committee staff at responses@finance.senate.gov by September 8, 2023. The questions are related to the following nine general areas.

- Marking-to-market for traders and dealers;
- Trading safe harbor;
- Treatment of loans of digital assets;
- Wash sales;
- Constructive sales;
- Timing and source of income earned from staking and mining;
- Nonfunctional currency;
- FATCA and FBAR reporting; and
- Valuation and substantiation.

The balance of this blog describes each area, lists each question, and discusses certain of them.

A. Marking-to-Market for Traders and Dealers

Under current section 475,[1] dealers in securities are required to "mark-to-market" any securities they hold (but are not required to mark-to-market securities held for investment for which an election is made). Dealers and traders in actively traded commodities and securities traders may elect mark-to-market treatment (but are not required to mark-to-market commodities or securities having no connection to their dealing or trading activities if an election is made). Mark-to-market, in this context, means that the dealer (or trader) treats all securities as if they were sold for their fair market value on the last business day of the taxable year (and the dealer or trader is taxable on the deemed gains and losses, even if the securities are not sold). For dealers and traders that elect mark-to-market treatment, gains and losses are treated as ordinary gains and losses.

On July 12, 2023, Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) reintroduced a revised version of the Lummis-Gillibrand Responsible Financial Innovation Act (the "RFIA") that would treat digital assets as commodities (and therefore permit dealers and traders in actively traded digital assets to elect mark-to-market treatment). [2]

The Senate Finance Committee has asked:

- Should traders of digital assets be permitted to mark to market? Why?
- Should dealers of digital assets be permitted or required to mark to market? Why?
- Should the answer depend on the type of digital asset? How should digital assets be determined to be actively traded (under IRC Section 475(e)(2)(A))?

Should traders of digital assets be permitted to mark to market? Why? Traders of digital assets should prefer the ability to elect mark-to-market treatment because it would be completely elective. Mark-to-market treatment would have the benefit for electing traders of generating ordinary losses, which can offset ordinary income. However, traders who elect mark-to-market treatment would generally accelerate income and would not benefit from long-term capital gains rates. If traders in digital assets that are thinly traded are permitted to mark-to-market their digital assets, mark-to-market treatment will increase valuation disputes with the IRS.

Should dealers of digital assets be permitted or required to mark to market? Why? Dealers in digital assets should prefer the ability to elect mark-to-market treatment (rather than being required to do so). Dealers that hedge inventory with offsetting positions should elect mark-to-market treatment because, under current law, they are subject to potential timing and character mismatches (i.e., current ordinary income upon a sale, offset by delayed capital losses with respect to offsetting hedging positions). A dealer that is subject to ordinary gain and an offsetting capital loss may be subject to tax with respect to the gain but may not be able to use the loss. On the other hand, mark-to-market treatment may accelerate gains, and those gains would not benefit from long-term capital gains rates. As a policy matter, elective treatment tends to minimize revenue as taxpayers who hold long-term tend not to elect mark-to-market treatment, while those who trade rapidly elect the treatment to generate ordinary losses without foregoing long-term capital gains. On the other hand, under current law, mark-to-market treatment is elective for commodities, and digital assets are most analogous to commodities. If the underlying digital asset is not actively traded, mark-to-market treatment will increase valuation disputes with the IRS.

B. Trading Safe Harbor

Under current law, non-U.S. persons engaged in a trade or business within the United States are subject to U.S. federal income taxation on a net income basis. Section 864(b)(2) provides that a non-U.S. person that trades in stocks or securities for their own account, or trades in commodities for their own account (but only if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated on such an exchange) is not engaged in a trade or business in the United States, and, therefore, is not subject to U.S. federal taxation on a net income basis, even if the trading is engaged in by an asset manager who is physically present in the United States. The trading safe harbor is not available for dealers.

The RFIA would amend section 864(b)(2) to expressly include an analogous safe harbor for trading in digital assets. The digital asset trading safe harbor would be limited to trading in digital assets of a kind customarily dealt in on a “digital asset exchange” (defined as a centralized or decentralized platform facilitating the transfer of digital assets) and only if the transaction is of a kind customarily consummated on such an exchange.

The Senate Finance Committee has asked:

- When should the policies behind the trading safe harbor (of encouraging foreign investment in U.S. investment assets) apply to digital assets? If those policies should apply to (at least some) digital assets, should digital assets fall under IRC Section 864(b)(2)(A) (trading safe harbor for securities), IRC Section 864(b)(2)(B) (trading safe harbor for commodities), or should the answer depend on the regulatory status of the specific digital asset? Why?
- Another possibility is that a new, separate trading safe harbor could apply to digital assets. In that case, should the additional limitation on commodities eligible for the trading safe harbor apply? Why?
- To the extent that the additional limitation on commodities for the trading safe harbor applies, how should the terms "an organized commodity exchange" and "transactions of a kind customarily consummated" (in IRC Section 864(b)(2)(B)(iii)) be interpreted in the context of different kinds of digital asset exchanges?

When should the policies behind the trading safe harbor (of encouraging foreign investment in U.S. investment assets) apply to digital assets? If those policies should apply to (at least some) digital assets, should digital assets fall under IRC Section 864(b)(2)(A) (trading safe harbor for securities), IRC Section 864(b)(2)(B) (trading safe harbor for commodities), or should the answer depend on the regulatory status of the specific digital asset? Why? The trading safe harbor was enacted to allow non-U.S. investors to hire U.S. investment managers to manage their stock, securities, and commodities without being subject to U.S. federal income tax. Absent the trading safe harbor, non-U.S. investors would be compelled to hire non-U.S. investment managers to avoid the U.S. federal income tax. This same reasoning applies equally to digital assets. The trading safe harbor has been limited to those activities that do not compete with traditional business activities that are subject to corporate tax. For this reason, the trading safe harbor does not protect dealers or (under the IRS's interpretation) taxpayers that engage in origination activity. Thus, the trading safe harbor should not apply to the dealer activities of digital asset dealers.

C. Treatment of Loans of Digital Assets

Under current law, transfers of securities in a securities lending transaction described in section 1058 are not subject to tax.[3] For these purposes, a “security” is defined by reference to section 1236(c) and means any “any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.” A digital asset does not qualify as a security under this definition and, therefore, it is unclear whether the tax-free treatment under section 1058 applies to loans of digital assets.

The “Green Book” accompanying the Fiscal Year 2023 and 2024 Budget proposed to expand section 1058 to apply to “actively traded digital assets” recorded on cryptographically secured distributed ledgers so long as the loan agreement contains similar terms to those currently required for loans of securities under section 1058. The Green Book would also require a lender to include in gross income amounts that would have been included had the lender not loaned the digital asset (i.e., “substitute payments”).

The RFIA also would expand the definition of “securities” for purposes of section 1058 to apply to digital assets and would require lenders to include in their gross income amounts that would accrue to them absent the digital asset loan.

<u>The Senate Finance Committee has asked</u>:

- Please describe the different types of digital asset loans.
- If IRC Section 1058 expressly applied to digital assets, would companies allowing customers to lend digital assets institute a standard loan agreement to comply with the requirements of that section? What challenges would compliance present?
- Should IRC Section 1058 include all digital assets or only a subset of digital assets? Why?
- If a digital asset is lent to a third party and the digital asset incurs a hard fork, protocol change, or air drop during the term of the loan, is it more appropriate for there to be a recognition of income for the borrower upon such transaction or subsequently by the lender when the asset is returned? Please explain.
    - Are there any other transactions similar to a hard fork, protocol change, or air drop that may occur during the term of a loan? If so, please explain whether it is more appropriate for the borrower or the lender to recognize income upon such transaction.

Should IRC Section 1058 include all digital assets or only a subset of digital assets? Why? The premise behind section 1058 is that the underlying asset is sufficiently liquid that a transfer to a counterparty that permits the counterparty to transfer it free and clear to a third party is a disposition for tax purposes (and not merely collateral for a loan), but that the taxpayer's contractual rights to receive back the asset and the payments made on the asset are not sufficiently different to justify current tax, especially in light of an overall capital markets policy to enhance market liquidity.[4] Arguably, the same policies apply equally to publicly traded digital assets, although there may be less of a consensus on the desire for liquidity in the digital asset market.

If a digital asset is lent to a third party and the digital asset incurs a hard fork, protocol change, or air drop during the term of the loan, is it more appropriate for there to be a recognition of income for the borrower upon such transaction or subsequently by the lender when the asset is returned? Please explain. If the borrower is entitled to retain the economic benefits of a hard fork, protocol change, or air drop, it would be more appropriate to tax the borrower. If the lender receives the economic benefits of these events, then it would be more appropriate to tax the lender (either immediately or when the asset is returned).

D. Wash Sales

A wash sale is a sale of an asset at a loss and a repurchase of that asset. Section 1091(a) currently disallows a loss from the sale of shares of stock or securities if the taxpayer reacquires the same or "substantially similar" stock or securities (or an option with respect to the stock or securities). Because cryptocurrencies are not considered "securities" for purposes of these rules under current law, the wash sale rules of section 1091 do not apply to digital assets, and crypto-investors have been able to obtain a tax benefit by "harvesting" tax losses during market downswings while retaining economic exposure.

On March 9, 2023, in the Green Book accompanying the Fiscal Year 2024 Budget, the Biden Administration proposed to apply the wash sale rules of section 1091 to digital assets.

The Senate Finance Committee has asked:

- In what situations do taxpayers take the position that economic substance (IRC Section 7701(o)) applies to wash sales with regards to digital assets?
- Are there existing best practices for reporting transactions in digital assets that are economically equivalent to wash sales?
- Should IRC Section 1091 apply to digital assets? Why or why not?
- Should IRC Section 1091 apply to other assets beyond digital assets? If so, what assets and why or why not?

Should IRC Section 1091 apply to digital assets? Why or why not? Section 1091 should apply to digital assets because the same policies that underlie section 1091 – i.e., that taxpayers should not be able to claim tax losses if they have not economically disposed of the underlying asset – apply equally to digital assets.

E. Constructive Sales

Under section 1259, if a taxpayer has an appreciated position with respect to stock, a debt instrument or partnership and enters into certain offsetting positions that eliminate all or substantially all of the taxpayer's economic exposure to that position, the taxpayer is treated as if it sold its appreciated position in a "constructive sale". The constructive sale rules of section 1259 do not apply to digital assets.

The Senate Finance Committee has asked:

- In what situations do taxpayers take the position that economic substance (IRC Section 7701(o)) applies to constructive sales with regards to digital assets?
- Are there existing best practices for reporting transactions in digital assets that are economically equivalent to constructive sales?
- Should IRC Section 1259 apply to digital assets? Why?
- Should IRC Section 1259 apply to other assets beyond digital assets? If so, what assets and why?

Should IRC Section 1259 apply to digital assets? Why? Section 1259 should be amended to apply to digital assets because the same policy that underlies section 1259 –that taxpayers should not be able to avoid tax if they have synthetically sold an appreciated security, debt instrument, or partnership interest – applies equally to digital assets.

F. Timing and Source of Income Earned from Staking and Mining

“Mining rewards” and “staking rewards” are the compensation (consisting of transaction fees and units of digital assets) paid to parties that validate new transactions and add them to the blockchain. Mining rewards are paid on protocols that use a “proof-of-work” mechanism, like Bitcoin and Ethereum. Staking rewards are paid on protocols that use a “proof-of-stake” mechanism.

In Notice 2014-21, the IRS held that mining rewards are includable in gross income when received at their fair market value. In the 2023 IRS Form 1040 instructions, the IRS held that both mining rewards and staking rewards are currently taxable.

On March 9, 2023, in the Green Book accompanying the Fiscal Year 2024 Budget, the Biden Administration proposed an excise tax of 30% of the costs of electricity used to mine digital assets.

The RFIA would provide that a taxpayer that receives digital assets from mining or staking is not taxed until the asset is sold or otherwise disposed of.

<u>The Senate Finance Committee has asked</u>:

- Please describe the various types of rewards provided for mining and staking.
- How should returns and rewards received for validating (mining, staking, etc) be treated for tax purposes? Why? Should different validation mechanisms be treated differently? Why?
- Should the character and timing of income from mining and staking be the same? Why or why not?
- What factors should be most important when determining when an individual is participating in mining in the trade or business of mining?
- What factors should be most important when determining when an individual is participating in staking in the trade or business of staking?
- Please describe examples of the arrangements for those participating in staking pool protocols.
- Please describe the appropriate treatment for the various types of income and rewards individuals staking for others or in a pool receive.
- What is the proper source of staking rewards? Why?
- Please provide feedback on the Biden Administration’s proposal to impose an excise tax on mining.

How Should Returns and Rewards Received for Validating (Mining, Staking, Etc.) Be Treated for Tax Purposes? In general, taxpayers are taxable when there is an "undeniable accession to wealth, clearly realized, and over which the taxpayers have complete dominion."[5] Although there are exceptions to this rule for certain self-created property, mining and staking rewards would not generally be self-created property that qualifies for deferral. Therefore, in most cases, this standard will be satisfied with respect to mining rewards. The standard would also be satisfied with respect to staking rewards (although there may be a dilutive effect).

Nevertheless, to the extent that a digital asset is not liquid and cannot easily be valued or sold, there are policy reasons to defer tax, at least for taxpayers without access to other sources of cash to pay the tax.

Should the Character and Timing of Income from Mining and Staking Be the Same? Why or Why Not? Both mining and staking represent periodic income that is more analogous to interest or periodic payments on swaps, which is generally ordinary income. Mining may be more directly analogous to services income (which is ordinary), whereas, for small holders of proof-of-stake digital assets who delegate their validation rights to third-party validators, the staking returns are more analogous to a passive return on an investment.

What is the proper source of staking rewards? Why? While mining is more directly analogous to providing services, the analogy is not perfect because mining is performed entirely by computers and does not involve meaningful labor. Also, services are typically sourced by reference to the place where the service is rendered, which is difficult to determine for mining. In contrast, staking – which is often delegated to third party validators – is more closely analogous to collecting a return on an investment. For swap income and foreign currency (each of which also defied easy characterization), income and gain was sourced by reference to the residence of the taxpayer.

G. <u>Nonfunctional currency</u>

Section 988(e) provides that an individual does not recognize gain upon the disposition of a nonfunctional currency if the transaction is a personal transaction (i.e., not in connection with a trade or business or an investment) and the gain does not exceed $200.

The RFIA would provide that no gain is recognized from the sale or exchange of a digital asset unless (1) the sale or exchange is for cash or cash equivalents, or if for property, the property is used by the taxpayer in the active conduct of a trade or business, or is investment property, and (2) the total value of the sale or exchange does not exceed $200 (adjusted for inflation) or the total gain which would otherwise be recognized with respect to the sale or exchange exceeds $200 (adjusted for inflation). For these purposes, all sales or exchanges which are part of the same transaction (or a series of related transactions) are treated as one sale or exchange.

The Senate Finance Committee has asked:

- Should a *de minimis* nonrecognition rule like the rule in IRC Section 988(e) apply to digital assets? Why?
- What threshold is appropriate and why?
- Are there existing best practices that would prevent taxpayers from avoiding tax obligations if a nonrecognition rule were to apply? What reporting regime would help taxpayers comply?

Should a de minimis nonrecognition rule like the rule in IRC Section 988(e) apply to digital assets? Why? For small personal transactions, the administrative cost of requiring taxpayers to report the gain and to enforce the tax is almost certainly less than the tax that would be generated. Although $200 is the amount in section 988(e), for significantly larger transactions. the administrative cost is likely greater than the revenue for considerably greater amounts. Therefore, a meaningfully higher threshold may be appropriate.

H. FATCA and FBAR reporting

1. *FATCA*

The Foreign Account Tax Compliance Act ("FATCA") is designed to detect and deter tax evasion by U.S. taxpayers that hold funds offshore. Chapter 4 of FATCA (or sections 1471-1474) requires foreign financial institutions to report to the IRS information about accounts held directly or indirectly by U.S. taxpayers. FATCA also requires brokers to report information about their customers to the IRS, including the identity, gross proceeds from sales of securities and certain commodities, and cost basis information for certain securities of customers.

The Green Book accompanying the Fiscal Year 2023 and 2024 Budget proposed to require financial institutions, including U.S. digital asset exchanges, to report information about certain passive entities and their substantial foreign owners and proposed to require digital asset brokers to report gross proceeds and other information with respect to their customers.

Chapter 4 of FATCA works together with section 6038D, which requires taxpayers with an interest in certain foreign assets with an aggregate fair market value of more than $50,000 during a taxable year to report the name and address of the financial institution where an account is maintained, the account number, and identifying information about assets not held in a financial account. Taxpayers subject to these reporting requirements must attach IRS Form 8938 (Statement of Specified Foreign Financial Assets) to their annual tax returns. For these purposes, "specified foreign financial assets" include foreign financial accounts and foreign non-account assets held for investment, such as foreign stock and securities, foreign financial instruments, contracts with non-U.S. persons and interests in foreign entities. Treasury and the IRS have requested the proper treatment of virtual currency under section 6038D, but no guidance has been issued yet. [6]

The Green Book accompanying the Fiscal Year 2023 and 2024 Budget proposed to amend section 6038D(b) to require reporting with respect to any account that holds digital assets maintained by a foreign digital asset exchange or other foreign digital asset service provider ("foreign digital asset accounts").[7]

In addition, section 6050I generally requires taxpayers that receive over $10,000 in cash in the course of the taxpayer's trade or business to report this receipt to the IRS on Form 8300.

The Infrastructure Investment and Jobs Act (the "IIJA") that was signed into law by President Biden on November 15, 2021, amended section 6050I to apply to receipts of digital assets. The IIJA's reporting requirements are effective for returns required to be filed and statements required to be furnished after December 31, 2023.

2. *FBAR*

The Bank Secrecy Act is designed to detect and prevent money laundering, financing of terrorism and threats to national securities due to financial crimes by U.S. persons. It generally requires U.S. taxpayers to report certain foreign financial accounts (such as bank accounts, brokerage accounts and mutual funds) to Treasury by filing the Financial Crimes Enforcement Network ("FinCEN") Form 114 (Report of Foreign Bank and Financial Accounts, or "FBAR"). The IRS has the authority to investigate potential violations of the Bank Secrecy Act.[8] Any U.S. person with a financial interest in, or signature or authority over, a bank, securities or other financial account in a foreign country, exceeding $10,000 in value at any time during the calendar year must file a Form 114.[9] It should be noted that filing Form 8938 does not relieve taxpayers of filing Form 114.

On July 27, Senators Elizabeth Warren (D-MA), Roger Marshall (R-KS), Joe Manchin (D-WV) and Lindsey Graham (R-SC) reintroduced the Digital Asset Anti-Money Laundering Act, which would classify certain participants in the digital asset ecosystem, such as wallet providers, miners and validators as "financial institutions" that are subject to the Bank Secrecy Act and require U.S. persons engaged in digital asset transactions greater than $10,000 through one or more offshore accounts to file an FBAR.

The Senate Finance Committee has asked:

- When do taxpayers report digital assets or digital asset transactions on FATCA forms (e.g. Form 8938), FBAR FinCEN Form 114, and/or Form 8300? If taxpayers report some categories and not others, please explain and identify which categories of digital assets are reported and not reported with respect to each of these forms.
- Should FATCA, FBAR, and/or 8300 reporting requirements be clarified to eliminate ambiguity about whether they apply to all, and/or some categories of, digital assets? Why?
- Given the policies behind FBAR and FATCA, should digital assets be more integrated into those reporting regimes? Are there barriers to doing so? What are they?
- How do stakeholders consider wallet custody when determining compliance requirements with FATCA, FBAR, and Form 8300? Please provide examples of wallet custody arrangements and identify which types of arrangements FATCA, FBAR, and/or Form 8300 reporting requirements should or should not apply to.

I. Valuation and substantiation on charitable donations of digital assets.

Current section 170(f)(11) disallows a deduction for contributions of property for which a deduction of more than $500 is claimed, unless the property has been appraised by a qualified appraiser.[10]

Section 170(f)(11)(A) provides an exception to the qualified appraisal rule for securities for which market quotations are readily available on an established securities market. Under current law, this exception does not apply to digital assets.

The Senate Finance Committee has asked:

- Digital assets do not currently qualify for the IRC Section 170(f)(11) exception for assets that have a readily available valuation on an exchange. Should the substantiation rules be modified to account for digital assets? If so, in what ways and for which types of digital assets? More specifically, would something different need to be done for those publicly traded digital assets?
- What are the characteristics of an exchange and the digital asset for which this exemption would appropriately apply and why?

Digital assets do not currently qualify for the IRC Section 170(f)(11) exception for assets that have a readily available valuation on an exchange. Should the substantiation rules be modified to account for digital assets? If so, in what ways and for which types of digital assets? More specifically, would something different need to be done for those publicly traded digital assets? The same policies that except readily valued property from the appraisal requirements apply to publicly traded digital assets (such as Bitcoin, Bitcoin Cash, Ether and Ripple). In general, if prices for a digital asset are as reliable as for securities for which market quotations are readily available on an established securities market, then no appraisal should be necessary for the digital asset,

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[1] All references to "section" are to the Internal Revenue Code.

[2] The original version of the RFIA was discussed here.

[3] To qualify for tax-free treatment under section 1058, the securities loan agreement must (i) provide for the return to the transferor of securities identical to the securities transferred; (ii) require payments made to the transferor of amounts equal to all interest, dividends, and distributions on the security during the term of the loan; (iii) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and (iv) meet other requirements as the IRS may prescribe by regulation. Section 1058(b).

[4] In other words, if tax was imposed on security loans, far fewer taxpayers would engage in them, and market liquidity would decline, although tax revenue would not necessarily increase.

[5] *Commissioner. v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

[6] T.D. 9706, 79 Fed. Reg. 73,817 (Dec. 12, 2014).

[7] Under the proposals, only taxpayers holding an aggregate value in excess of $50,000 (or a higher amount prescribed by the IRS) in foreign digital asset accounts and the other foreign assets subject to section 6038D.

[8] 31 U.S.C. Sec. 5311 *et seq*.

[9] 31 U.S.C. Sec. 5314.

[10] This requirement is deemed satisfied if, (i) with respect to a contribution of property for which a deduction of more than $500 is claimed, the individual, partnership or corporation (but not a personal service C corporation or closely held C corporation) includes a description of the property and other information required by the IRS with the return for the taxable year in which the contribution is made; (ii) with respect to a contribution of property for which a deduction of more than $5,000 is claimed, the individual, partnership or corporation obtains a qualified appraisal of such property and attaches the appraisal and information required by the IRS about the property to the return for the taxable year in which the contribution is made; and (iii) with respect to a contribution of property for which a deduction of more than $500,000 is claimed, the individual, partnership or corporation attaches a qualified appraisal of the property to the return for the taxable year in which the contribution is made. Section 170(f)(11)(B)-(D).

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