Chamber of Digital Commerce Principles and Framework for Appropriate Digital Asset Tax Policy in the United States

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A. Introduction

The Chamber is the world's largest trade association representing members in the digital asset and blockchain industry. Our mission, supported by a diverse and global membership of nearly 200 members, is to promote the acceptance and use of digital assets and distributed ledger technology ("DLT").

Through education, advocacy, and close coordination with policymakers, regulatory agencies, and industry across various jurisdictions, our goal is to develop a pro-growth legal environment that fosters innovation, job creation, and investment. We represent the world's leading innovators, operators, and investors in the digital asset and blockchain technology ecosystem, including leading edge start-ups, software companies, global IT consultancies, financial institutions, insurance companies, law firms, and investment firms.

B. U.S. Taxpayers Need Guidance to Meet Compliance Expectations

Blockchain technology adoption and digital asset markets have grown significantly since the IRS issued Notice 2014-21[1] and Revenue Ruling 2019-24.[2] However, published tax guidance relating to digital asset transactions has not kept pace. This disparity creates risk for taxpayers seeking to comply, wastes IRS audit resources, dampens commercial activity and economic recovery, and stifles U.S. innovation.

C. The IRS Should Adopt the Following Guiding Principles for Digital Asset Tax Policy Issues

Fairness. Tax rules are most effective when they are viewed as fair, reasonable, and based on sound tax and economic principles. Stakeholders include taxpayers, government, and intermediaries charged with assisting others in tax compliance (*e.g.*, information reporting and tax preparation).

Consistency. In addition, tax rules should be based on generally accepted principles of tax law, outline exceptions based on policy grounds, and interpret grey areas to promote economic growth without jeopardizing the U.S. tax base.

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[1] IRS Notice 2014-21.
[2] IRS Rev. Rul. 2019-24. *See also*, IRS, MEMORANDUM ON BITCOIN/BITCOIN CASH HARD FORK (APR. 9, 2021), https://www.irs.gov/pub/irs-wd/202114020.pdf.

Technology-neutral. Technology-neutral principles have grounded the development of U.S. tax law as new asset classes and business models have emerged. Notional principal contracts, e-commerce, and cloud-based transactions are some examples.

Tax rules for digital assets should follow this approach and promote financial and commercial innovation.

D. A Forward-looking Digital Asset Tax Policy Strengthens U.S. Growth and Competitiveness

Given the exponential growth in digital assets, their many use cases, and the international competitiveness blockchain and digital asset adoption possess, the IRS must establish among its top priorities addressing digital asset-related tax issues. This is particularly important given the prominence of the virtual currency question on IRS Form 1040 and the potential for controversy involving millions of taxpayers arising from the lack of clear rules. Further, over 86% of developed countries are exploring the issuance of central bank-issued digital currencies ("CBDCs") and a tax policy framework that incorporates digital assets is seen as necessary readiness for engaging with CBDCs.[3]

Promoting economic activity, entrepreneurship, investment, innovation, and collaboration is what led to the United States having the world's largest economy. Tax considerations should be a driving factor to advance digital assets and not a reason to tap the brakes, particularly as the global economy seeks to recover from the COVID-19 pandemic.

E. The Framework: Top Digital Asset Tax Policy Issue Areas Needing Clarity and Guidance

1. Digital Asset Lending

Taxpayers seeking to mobilize their financial assets to increase returns has long been a mainstay of traditional finance and financial markets. Such mobilization has involved loans of dollars, foreign currencies, stock, and bonds. The recent uptick of digital asset lending is merely a continuation of this well-established trend. Providing guidance that prescribes instances in which lending of digital assets will not be treated as a taxable disposition:

- Affords businesses a greater pool of capital from which to undertake a recovery,
- Lowers borrowing costs (due to the increased pool of available capital to lend),
- Increases returns on digital assets for lenders, many of whom are Main Street investors,
- Provides an alternative source of capital for borrowers without access to traditional markets,

[3] Codruta Boar and Andreas Wehrli, Ready, Steady, Go? – Results on the Third BIS Survey on Central Bank Digital Currency (Jan. 2021), https://www.bis.org/publ/bppdf/bispap114.pdf.

- Reduces whipsaw potential by placing taxpayers seeking to lend built-in-loss assets on the same footing as taxpayers seeking to lend built-in-gain assets,

- Increases the liquidity required for healthy and stable markets, enabling increased growth and further innovation, and

- Facilitates the efficient use of capital in the United States as compared to non-U.S. jurisdictions that have chosen to engage and provide guidance.

2. Information Reporting for Digital Asset Transactions

a. Chapter 61

We understand Congress and the IRS are currently working on information reporting rules related to digital assets.[4] Information reporting by third parties, such as employers, financial institutions, and certain intermediaries, is an important feature of the U.S. tax system to ensure compliance. A recent Treasury Inspector for General Tax Administration ("TIGTA") report indicates that tax compliance rates increase to above 95% when there is effective information reporting.[5] The uncertain manner in which the information reporting rules apply to many transactions involving digital assets, most notably the broker-reporting rules of section 6045, likely contributes to any gap of taxable activity. Consistent with the past two Government Accountability Office ("GAO") reports dating back to 2013,[6] we recommend that Treasury and the IRS prioritize proposed rules under Chapter 61 relating to transactions involving digital assets and the ways in which they are traded.[7] Better information reporting would reduce the compliance burden on the IRS.

Appropriate information reporting will benefit both taxpayers (for compliance) and government (for revenue). Furthermore, taxpayers will be spared the forensic exercise of piecing together their annual trading history across multiple venues. Concurrently, the IRS will have third-party confirmation that a taxpayer is reporting all of their transactions occurring on domestic exchanges which involve digital assets.

The increased entrance of retail investors in digital asset markets underscores the need for additional guidance. The IRS has signaled to taxpayers filing individual tax returns that digital asset transactions must be included but it has not provided meaningful instructions to help

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[4] *The 2021 Filing Season and 21st Century IRS: Hearing Before the S. Comm. on Finance*, 117th Cong. (2021) (statement of Rob Portman, U.S. Senator).
[5] Treasury Inspector General for Tax Administration, *The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions*, p. 5 (Sept. 24, 2020), https://www.treasury.gov/tigta/auditreports/2020reports/202030066fr.pdf. *See also* General Accountability Office, GAO-20-188, Virtual Currencies: Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance 27 (2020), https://www.gao.gov/assets/710/704573.pdf.
[6] General Accountability Office, GAO-13-516, Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks (2013), https://www.gao.gov/products/gao-13-516; General Accountability Office, GAO-20-188, Virtual Currencies: Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance 27 (2020), https://www.gao.gov/assets/710/704573.pdf.
[7] See CHAMBER OF DIG. COMMERCE, *IRS Comment Letter on Information Reporting for Virtual Currency Transactions* (Apr. 3, 2020), https://digitalchamber.org/wp-content/uploads/2020/04/Chamber-of-Digital-Commerce-IRS-Comment-Letter-on-Information-Reporting-for-Digital-Asset-Transactions.pdf.

taxpayers comply with their obligations. Digital asset transactions are now commonplace on Wall Street and Main Street. It is unfair to further the efforts on enforcement without commensurate efforts to clarify the rules around tax reporting for the retail investor. These points are consistent with efforts to reduce the annual $1 trillion annual tax gap recently reported by Commissioner Rettig.[8]

b. Foreign Account Tax Compliance Act (FATCA)

Information reporting guidance should also address the application of FATCA to digital assets, including determinations of “foreign” acocunts and whether digital assets are “financial assets” for purposes of Chapter 4. This addresses potential gaps in Chapter 61 reporting where U.S. taxpayers trade on foreign exchanges or interact with other financial intermediaries, and aligns tax reporting for digital assets with the direction of the OECD and the European Union as it relates to the Common Reporting Standard and DAC 8, respectively.

3. Foreign Bank Account Reporting (FBAR) Requirements

In the traditional context, FBAR requires U.S. citizens to disclose to the government via the FBAR form that they have assets in a foreign financial account. The reporting obligation arises where the custodian is not subject to U.S. law and will not be reporting those funds to U.S. regulators. Given the digital nature of digital asset account relationships, however, it may not be clear where the financial institution is “located” given entities often have no physical locations and users open accounts online. Instead, we recommend the determination center on the entity that contractually holds the private key to the wallet. We believe that focusing on the location of the financial institution storing the digital assets’ private keys with rights to control the assets in question is a simpler approach.

4. Classification of Digital Assets

Different countries have outlined separate categories of digital assets for tax purposes. Some of these include security tokens, exchange tokens, utility tokens, and stablecoins.[9] The IRS has not gone so far, as such labels would likely have little meaning for U.S. tax purposes. However, many practitioners focus on whether and when a digital asset is a commodity for U.S. tax purposes. This question has relevance in a number of contexts, including but not limited to, sections 864(b) (foreign income – trade or business), 475(f) (mark to market accounting for securities dealers), 6038D (information reporting for foreign financial assets), 6045 (returns of brokers), and 7704(d)(1)(G) (publicly-traded partnerships treated as corporations). Consideration should also be given to whether a digital asset is a security for tax purposes under the following Code provisions: sections 1092(d) (straddles), 851 (regulated investment companies), 351(e) (transfer to corporation controlled by transferor), 721(b) (nonrecognition of gain or loss on contribution), 731(c) (treatment of marketable securities), and 864(b)(2)(B) (trading in commodities).

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[8] *The 2021 Filing Season and 21st Century IRS: Hearing Before the S. Comm. on Finance*, 117th Cong. (2021) (statement of Chuck Rettig, Internal Revenue Serv. Comm’r).
[9] *See*, *e.g.*, *Cryptoassets Manual*, HM Revenue & Customs (Mar. 30, 2021), https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto10100.

Other categorizations for U.S. tax purposes may also be appropriate, including intangible property categorization. This could apply, for example, where a taxpayer uses a digital asset as part of its infrastructure in storing data, interacting with other blockchains, and/or processes transactions or blockchain data.

5. Proof of Stake Protocols

The IRS has not offered guidance to date on the taxation of staking rewards. An increasing number of protocols are being launched that offer proof of stake ("POS") rewards and many other protocols evolving in this direction. Each protocol functions differently with a growing number of questions for the IRS to address. Many other countries have offered guidance on this topic. Some questions the IRS must consider are:

- In what instances should staking rewards be considered income?
- In the event that staking rewards are considered income, how should taxpayers think about sourcing and active vs. passive issues?
- What are the considerations of character (capital vs. ordinary) if the rewards are subsequently sold or exchanged?
- Should staking rewards be taxed as property transferred in connection with performance of services?
- Are staking rewards considered trade or business income?

F. Conclusion

The foregoing topics have been chosen because of their importance in producing rules relating to tax compliance with respect to digital assets. These are the fundamental issues that must be addressed before the IRS addresses other, more novel digital asset-related topics. Commercial activity and innovation in the digital assets space is increasing rapidly. Decentralized finance ("DeFi"), non-fungible tokens ("NFTs"), and other developments have seen explosive growth. The IRS cannot continue to fall behind and needs to engage with clarifying guidance. The Chamber remains active in developing these issues and would welcome the opportunity to serve as a resource, potentially through in-person or virtual meetings in the coming months.