

Blockchain Asset Tax Planning: Emerging Issues with Respect to Cryptocurrencies, NFTs, and Other Digital Assets

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Joshua Becker is a manhattan based tax attorney with over 10 years of international law firm and accounting firm experience.

Joshua counsels clients in a diverse range of tax, business, and private wealth matters. His experience includes the tax and non-tax aspects of investment fund formations, private equity mergers and acquisitions, hedge funds, family office operational and investment structures, and real estate joint ventures and investments. Prior to joining Pillsbury, Joshua was a founding member of a multi-family office and registered investment advisor dedicated to blockchain and digital asset investors, founders, and entrepreneurs.

Joshua is a regular writer and speaker on partnership tax, blockchain assets, and family office structures. Joshua was recently named a Top 15 U.S. Legal Crypto Practitioner for 2022 by *Citywealth*.

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Chris is the head of tax at Digital Currency Group (DCG) and handles all things tax from an operational, compliance, and strategic perspective. In his role, he also supports DCG's subsidiaries on strategic tax initiatives.

Prior to joining DCG, Chris worked in EY's Financial Services Office for 13 years, and served as a tax lead in EY's Metro NY Fintech initiative. He advised fintech companies at all stages and served as a subject matter expert for digital assets, supporting varied teams on tax technology and complex tax issues. During his time at EY, Chris also spoke at both internal and external conferences on the latest developments around the taxation of digital assets, including EY's Executive Tax Update and Domestic/International Tax Conferences, as well as the Banking & Capital Markets Tax Institute and Coindesk's Consensus Invest.

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Blockchain Asset Tax Planning:

Emerging Issues with Respect to Cryptocurrencies, NFTs, and Other Digital Assets

1. Foundational issues: money, security, or commodity
2. Transactions involving Blockchain Assets
3. Blockchain Operational Issues
4. Blockchain Asset Reporting
5. Blockchain Assets and Treatment under Tax Incentive Programs
6. Lummis-Gillibrand Proposals

Focus of Today's Presentation:

- Our panel will discuss the latest IRS guidance and offer advice on planning opportunities with respect to the taxation of cryptocurrencies, NFTs, and other digital assets, with a particular focus on tax planning strategies and considerations for entrepreneurs, founders, and venture capital investors within the blockchain ecosystem.

1. Foundational issues: money, security, or commodity

What are Blockchain Assets? Good question...

- Blockchain basics –
 - Blockchain defined: Blockchain is a shared, immutable ledger that facilitates the process of recording transactions and tracking assets in a business network. An asset can be tangible (a house, car, cash, land) or intangible (intellectual property, patents, copyrights, branding). Virtually anything of value can be tracked and traded on a blockchain network, reducing risk and cutting costs for all involved.
 - Blockchain assets include:
 - Cryptocurrencies as Digital Cash.
 - Stablecoins, Privacy coins.
 - Utility tokens.
 - Security tokens.
 - Non-fungible tokens (NFTs)
 - Decentralized applications (DApps)
- “Blockchain Assets”
 - broadest term to use in this ecosystem (rather than, for example, “cryptocurrencies,” which would not include various other assets relevant to today’s discussion)

How does the the tax code and current IRS guidance treat blockchain assets? Generally as property, but uncertainty remains.

- Notice 2014-21
 - Virtual currency is treated as **property** for tax purposes.
 - If you are paid in virtual currency, you have to report it to the same extent as any other payment made in property.
 - If you pay it to independent contractors, you might have to issue a Form 1099.
 - If you pay an employee's wages using virtual currency, you have to withhold and issue Form W-2.
 - If you are a third party settling payments in virtual currency on behalf of merchants, don't forget about Form 1099-K.
 - Gains or losses from sales or exchanges of virtual currency are capital or ordinary depending upon whether virtual currency is a capital asset in the hands of the taxpayer.
 - Mining awards are taxable! (proof of work).

How does the the tax code and current IRS guidance treat blockchain assets? Generally as property, but uncertainty remains.

- Revenue Ruling 2019-24
 - Addresses “hard forks” and “airdrops” and whether they give rise to gross income to holders of cryptocurrency and Section 61.
 - Hard forks = when a cryptocurrency undergoes a protocol change resulting in it being recorded on a new distributed ledger (resulting in a new, parallel blockchain).
 - Under Revenue Ruling 2019-24, income NOT generally recognized.
 - Airdrops = a means of distributing units of a cryptocurrency to the addresses of multiple taxpayers
 - Income IS generally recognized (accretion of wealth)
 - IRS looks at “dominion and control” on the date that the airdrop is recorded on the distributed ledger.

How does the the tax code and current IRS guidance treat blockchain assets? Generally as property, but uncertainty remains.

- Uncertainty with respect to –
 - Treatment of particular blockchain assets used in non-recognition transactions (see Section 2 of this presentation).
 - Different treatment for different blockchain assets.
 - Treatment of staking awards.

2. Transactions involving Blockchain Assets

Transactions involving Blockchain Assets – General Rule.

- Transfers of blockchain assets and non-recognition treatment:
 - Taxable transfers –
 - As mentioned above, a transfer of a blockchain asset (e.g., cryptocurrency) is treated as a taxable disposition of the applicable blockchain asset.
 - Not treated as money!
 - In effect, the IRS guidance to date treats the transferor of a blockchain asset as having sold such blockchain asset for cash followed by a payment of such cash to the service provider or property seller.

Transactions involving Blockchain Assets – Non-Recognition Provisions.

- Corporate
 - Section 351: Transfers of blockchain assets to a corporation in exchange for stock.
 - Does Section 351(e)(1) apply?
 - It depends... are the applicable blockchain assets properly treated as “stock or securities” for ***U.S. federal income tax purposes?***
- Partnership
 - Section 721(a): Transfers to partnerships in exchange capital interest.
 - Does Section 721(b) apply?
 - Same issue as Section 351(e)(1) above.
 - Section 731(a): Distributions of blockchain assets from a partnership to partners.
 - Does Section 731(c) apply?
 - It depends... are the applicable blockchain assets treated as “cash or marketable securities” for ***U.S. federal income tax purposes?***
 - ***Query: stable coins treated as underlying asset? (USD, etc.)***

Lending Transactions – Getting liquidity without selling and triggering capital gains taxation.

- Tax free liquidity products are hugely important for founders and investors who may find themselves holding significant positions in various blockchain assets with little to no liquidity relative to net worth.
- For both bullish economic and tax mitigation reasons, some founders and investors would rather pay interest on tax-free loan proceeds than sell blockchain assets (often BTC or ETH) and thereby trigger capital gains tax and reduce participation in future upside.

Lending Transactions

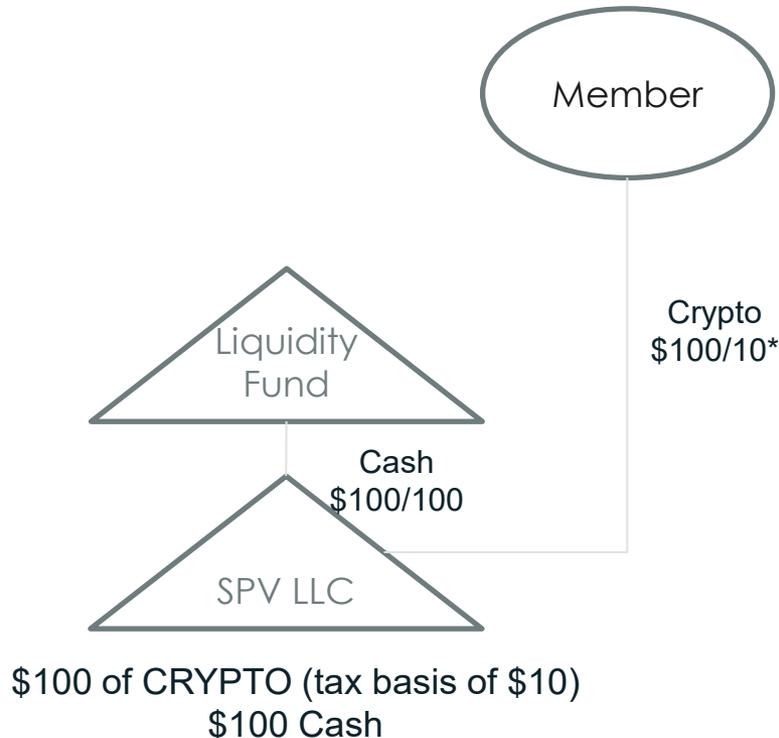
- Lending against blockchain assets (usually BTC or ETH):
 - Must be true debt
 - Look at traditional debt v equity factors, including:
 - Label/name
 - Fixed maturity date
 - Sources of payments (limited to only profits?)
 - Right to enforce payments
 - Participation in management
 - Status in relation to other creditors
 - Intent of the parties
 - Creditworthiness of debtor
 - Thin capitalization

Lending Transactions

- Borrowing blockchain asset:
 - Section 1058 provides that no gain or loss is recognized by the owner of “securities” when the owner transfers the securities for the contractual obligation of the borrower to return identical securities. The §1058 safe harbor is limited to exchanges of “securities” which are narrowly defined for purposes of §1058 by §1236(c).
 - Since the 1926 Supreme Court decision in *Provost v. United States*, a securities loan has been characterized as a disposition of the loaned securities by the lender. This applies as well to a bitcoin loan. Despite being a disposition, the loan is not necessarily treated as a realization event if the contractual obligation received by the lender in exchange does not differ materially in either kind or extent to the property transferred to the borrower; instead, the exchange may be treated as the lender having agreed to substitute a personal obligation, wholly contractual, of the borrower to restore the lender, on demand, to the economic position in which he would have been had the loan transaction not occurred.
 - **Lummis-Gillibrand proposed legislation would explicitly provide that Section 1058 applies to “digital assets,” which is a very broad term under the legislation.**

Liquidity Transactions – Hybrid (debt/equity) alternatives?

SPV LLC



- Member contributes \$100 of CRYPTO with a tax basis of \$10 (built-in gain of \$90) to SPV LLC in exchange for a \$100 Junior Preferred Equity Interest in SPV.
- Liquidity Fund contributes \$100 of cash to SPV LLC in exchange for a \$100 Senior Preferred Equity Interest in SPV.
- See following slide outlining terms of SPV LLC waterfall.

*Book Value / Tax Basis

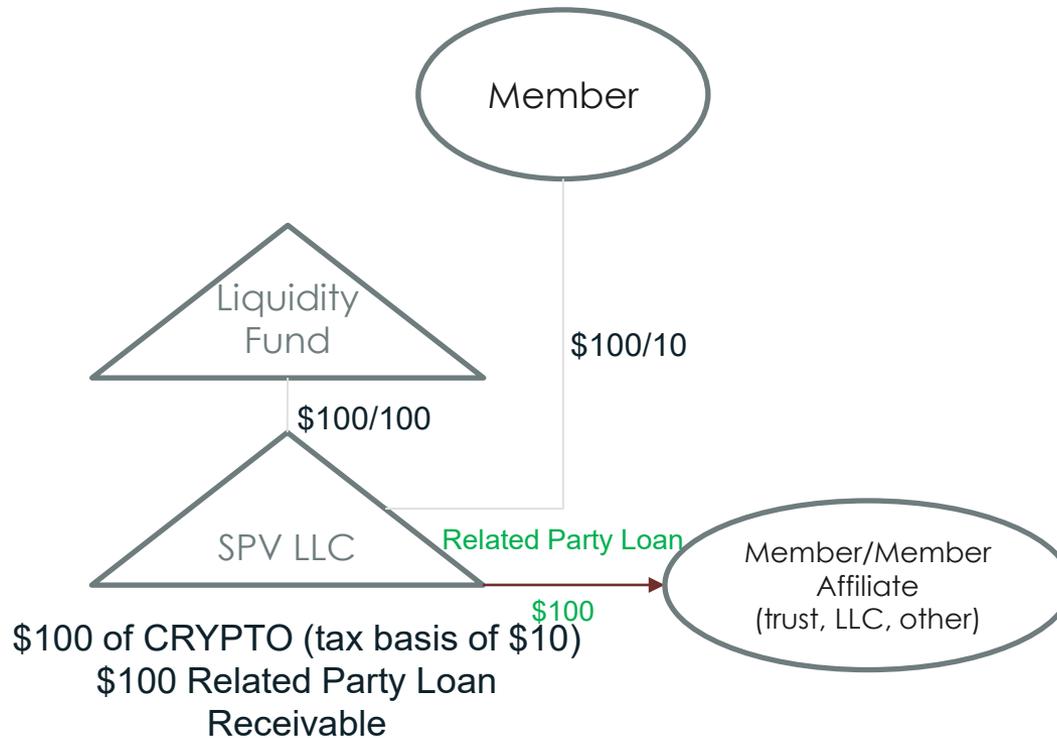
Liquidity Transactions – Hybrid (debt/equity) alternatives?

Terms of SPV LLC Waterfall

Distributions shall be made to the SPV LLC members in the following order of priority:

- First, to the Liquidity Fund until it has received a 15% IRR on its capital contributions (i.e., \$100 + 15% return)
- Second, to the Member until it has received cumulative distributions equal to its capital contributions (i.e., \$100);
- Thereafter, 50% to the Member and 50% to the Liquidity Fund.

Liquidity Transactions – Hybrid (debt/equity) alternatives?



SPV Makes Loan to Member Affiliate

- SPV makes a [10]-year balloon payment loan of \$100 to the Member or an affiliate of the Member (trust, LLC, other) (the “Related Party Loan”).
- The interest rate applicable to the Related Party Loan would be equal to or greater than published AFR.
- Member (or Member affiliate) uses Related Party Loan proceeds to purchase personal assets (e.g., home) or to invest in other investment assets (e.g., investments funds, etc.).

Constructive Sales

- Section 1259(a)(1) provides that if there is a constructive sale of an “**appreciated financial position**,” the taxpayer must recognize gain as if the appreciated position were sold at its fair market value on the date of such constructive sale. Any gain is taken into account for the taxable year during which the constructive sale occurred. If a constructive sale of an appreciated financial position occurs, the basis and holding period of the appreciated financial position are to reflect the constructive sale.
- An appreciated financial position is defined to mean “any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value.” **Based upon the definition of appreciated financial position, bitcoin, including futures or derivatives on bitcoin, seem unlikely to be treated as appreciated financial positions for purposes of §1259.**
- A taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer enters into a short sale of, or a futures or forward contract to deliver, the same or substantially identical property.

Wash Sales

- Currently don't apply to blockchain assets.
- Many proposals to date to change this (however, NOT included in Lummis-Gillibrand proposals).

3. Blockchain Operational Issues

Decentralized Autonomous Organizations (DAOs) – What are they?

- Definition of a DAO:
 - a blockchain-based form of organization or company that is often governed by a native crypto token. Anyone who purchases and holds these tokens gains the ability to vote on important matters directly related to the DAO. They typically use smart contracts in place of traditional corporate structures to coordinate the efforts and resources of many towards common aims. These are self-executing computer programs that carry out a particular function when certain conditions are met.
 - Ethereum is the second-largest cryptocurrency by market capitalization and is the largest platform for using the technology behind cryptocurrency – blockchain – for uses beyond money. The thought is that if bitcoin can do away with middlemen in online payments, can the same or comparable technology do the same for middlemen in companies? What if entire organizations could exist without a central leader or CEO running the show?
 - Source: <https://www.coindesk.com/learn/what-is-a-dao/>

Decentralized Autonomous Organizations (DAOs) – Applicable tax treatment.

- Corporations, partnerships, other?
 - If partnership, can publicly traded partnership rules apply in certain instances?
 - Definition of a general partnership: a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.
- For an in-depth review of this topic, see Shakow, David J., The Tao of the DAO: Taxing an Entity that Lives on a Blockchain (August 13, 2018). Tax Notes, Vol. 160, Pg. 929, August 13, 2018, U of Penn, Inst for Law & Econ Research Paper No. 18-23, Available at SSRN: <https://ssrn.com/abstract=3247155>

Decentralized Autonomous Organizations (DAOs) – Lummis-Gillibrand proposals.

- Lummis-Gillibrand proposed legislation would treat most DAOs as “business entities,” with certain exceptions.
 - Exceptions:
 - Treasury management
 - Raising funds for a charitable purpose

Decentralized Autonomous Organizations (DAOs) – Structuring around DAOs.

- Popular structure:
 - Facts: Place DAO governance tokens instead LLC, rather than having holders hold tokens directly.
 - Benefit:
 - In the event that the DAO is considered engaged in a taxable business activity, the LLC would report income to members via Schedule K-1s.
 - Downside:
 - Potential need to distribute “zero” Schedule K-1s.
 - Potentially takes away from the “distributed” concept of a DAO.
- See Wyoming “DAO” LLC

Taxation of Mining Awards – Taxable upon receipt.

- Under 2014 IRS guidance (mentioned above), mining awards are taxable.
- Under Lummis-Gillibrand proposals, awards would NOT be taxable until a disposition.

Taxation of Staking Awards – Taxable upon receipt... maybe?

- If 2014 IRS guidance with respect to mining applies, staking awards would be taxable upon receipt.
- Reasons why staking awards should receive different treatment:
 - Fundamentally different activities
 - Risk of loss in staking activities
 - Dilution argument – true accretion of wealth is NOT equal to gross value of awarded tokens.
 - See Landoni, Mattia and Sutherland, Abraham, Dilution and True Economic Gain from Cryptocurrency Block Rewards (2020). 168 Tax Notes 1189, 2020, Available at SSRN: <https://ssrn.com/abstract=3672461>
- IRS position changing? *Jarrett v. US* may show signs of a change in IRS approach.
- Taxpayer reporting options
 - Alternative reporting (inconsistent with 2014 IRS guidance for mining)
 - Disclosures

4. Reporting and Compliance

Blockchain asset reporting – FBAR obligations?

- **FBAR filings may not apply.** Cryptocurrency held in a hardware or software wallet controlled directly and only by its owner, may not be a reportable account even if it is held in a safety deposit box maintained in a foreign country; however, as noted below, control over the contents must be limited.
- The Internal Revenue Manual lists the following as not being considered financial accounts:
 - Stocks, bonds, or similar financial instruments held directly by the person.
 - Real estate or an account holding solely real estate.
 - A safety deposit box; however, a reportable account may exist where the financial institution providing the safety deposit box has access to the contents and can dispose of the contents upon instruction from, or prearrangement with, the person.
 - Precious metals, precious stones, or jewels held directly by the person;
- **Protective filing?** Those required to file an FBAR who fail to properly file a complete and correct FBAR may be subject to significant penalties; thus, filing an FBAR is often recommended in uncertain situations.

Blockchain asset reporting – FATCA

- **FATCA Generally.** FATCA requires certain U.S. taxpayers who hold foreign financial assets with an aggregate value of more than the reporting threshold (at least \$50,000) to report information about those assets on Form 8938, which must be attached to the taxpayer's annual income tax return. The reporting threshold is higher for certain individuals, including married taxpayers filing a joint annual income tax return and certain taxpayers living in a foreign country.
- **Applicability to crypto.** Generally, an account at a financial institution located outside the U.S. that holds cryptocurrency on behalf of a U.S. person seems likely to be treated as a specified foreign financial asset. The beneficial owner normally does not directly control the private keys to the cryptocurrency, and such arrangements are sometimes referred to as “hosted wallets.”;

Blockchain asset reporting – Non-US Person obligations.

- Certain DeFi protocols may give rise to effectively connected income and thus a US tax filing requirement.
- Similarly, some DeFi protocols may be treated as debt investments which are subject to 30% US withholding.
- Takeaway: Non-US Persons should carefully consider how they hold blockchain investments that may have a US nexus and thus tax exposure.

Blockchain asset reporting – Other issues

- Form 8949.
- Form 8275 for uncertain positions.

M&A Tax Diligence – How to deal with target risk

- Is there a “market” standard with respect to allocating certain risks?
- Tax rep and warranty insurance – can this cover certain risks?
- Don’t forget about SALT exposure!

5. Blockchain Assets and Treatment under Tax Incentive Programs

Blockchain asset reporting – Other issues

- Blockchain Investments within Qualified Opportunity Funds.
 - Overview:
 - Reinvest capital gain proceeds into a “business” actively engaged in blockchain activities (e.g., defi development, etc.)/
 - Defer tax on reinvested capital gains until December 31, 2026 (effectively until 2027).
 - If a taxpayer holds a qualified opportunity fund for 10-years or more, appreciation on blockchain business interest held in such fund may be excluded from taxation when realized.
 - Tax advantaged way of making DeFi investments!
- QSBS and blockchain activities
 - Similar to QOF strategies;
 - Ability to rollover tax deferred;
 - 5-year hold requirement.

6. Lummis Gillibrand Proposals

Lummis-Gillibrand

- Maintains treatment of crypto as “property” but creates many exceptions to what would otherwise be the tax treatment if consistently treated as property for all purposes under the Code.
- Definitions – the proposal includes various definitions for blockchain assets. While the most “general” term under the proposed bill is “digital asset,” the legislation includes other sub-categories which may receive different treatment, for both tax and non-tax purposes.
- In addition to the provisions mentioned above, the proposal also includes:
 - A de minimis exception that excludes from income capital gains from the disposition of “virtual currency,” a subset of digital assets, in personal transactions that do not exceed \$200, which parallels the existing \$200 exclusion for dispositions of foreign currency in personal transactions.
 - An expanded trading safe harbor for non-U.S. persons to include generally their trading in digital assets, provided that the digital assets are of a kind customarily dealt in on a digital asset exchange and the transaction is of a kind customarily consummated on such an exchange.
 - Call to IRS to issue guidance in various areas, including relating to charitable contributions of digital assets.

Where are we going from here?

- Where will the industry be in 5 years?
- How will the Code and IRS guidance evolve over the next 5 years?
- Will the tax rules continue to lag innovation in the ecosystem?
- Politics, politics, politics!!