12:45 – 1:45 p.m.

Cryptocurrency Taxes: Implications, Planning & Strategies

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Crypto Tax Deep Dive

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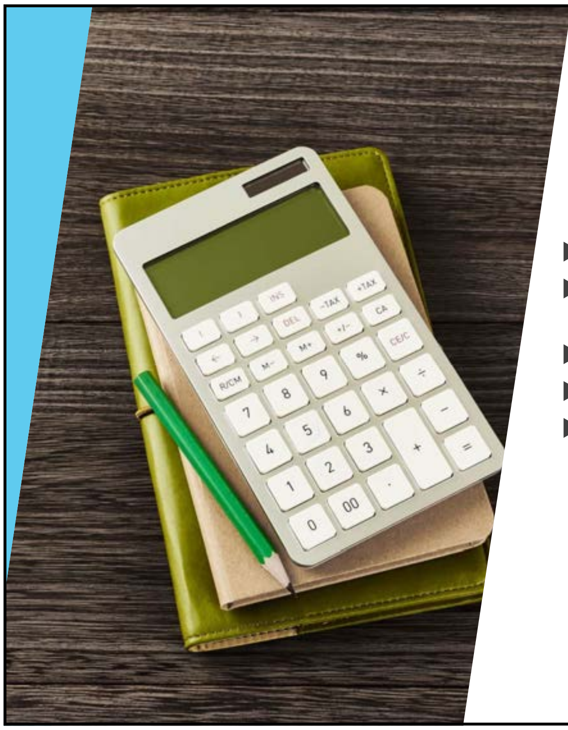
About me

- Dr. Sean Stein Smith, CPA, CMA, CGMA, CFE
- Assistant Professor, Lehman College, City University of New York
- Forbes Contributor - Crypto & Blockchain
- AICPA Outstanding CPA of the Year (2022)
- Accounting Today Top 100 Most Influential People in Accounting
- E.C. Harwood Visiting Research Follow - American Institute of Economic Research
- Board of Advisors - Wall Street Blockchain Alliance (WSBA)
- Chair, Accounting Working Group, WSBA
- Advisory Board Member - Gilded "Crypto Accounting Made Simple"
- Strategic Advisor - Crescent City Capital
- 40 under 40 in Accounting (2017-2021)
- NJCPA Trustee (2022 FY)



Agenda

- Quick market update & FAQs
- Decentralized Finance (DeFi) activities
- Non-fungible tokens
- Stablecoins
- Taxes and organizational implications

Market update

Agenda

- U.S. GAAP cryptoasset update and open items
  - Implications for organizations holding/using crypto
- Federal and state crypto update
  - Tax planning implications
- Corporate Transparency Act
  - Introduction & overview

Ethereum merge, recap.

- The Ethereum merge has successfully been completed (September 2022)
  - Ethereum blockchain has converted from Proof-of-Work consensus to Proof-of-Stake consensus
  - Energy consumption will decline by approximately 99% as a result
  - Opens the door for further pivoting away from BTC to ETH as crypto market leader
- Tax accounting has not changed
  - More on that later
- Financial accounting has not changed
  - Not yet at least

Is ether a security?

- Same day as ETH merge completing, SEC chair Gary Gensler offered testimony that staked crypto could qualify as securities
- Meet criteria of the Howey Test as an “investment contract”
- https://cointelegraph.com/news/ether-staking-could-trigger-securities-laws-gensler

ETHPoW Fork?

- Speculated to possibly cause some issues with regards to the appetite/market post-merge
- Appealed to PoW miners looking to remain in business
- Token crashed up to 75% at worst declines following the merge
  - (24-36 hours after)
- Is showing signs of gaining popularity with some non-U.S. mining pools, etc.
- https://cointelegraph.com/news/does-ethereum-s-new-ethpow-fork-stand-a-chance-ethw-price-falls-65-post-merge
- https://news.bitcoin.com/new-ethereum-pow-fork-gathers-60-terahash-from-well-known-pools-ethws-price-shudders-39-in-24-hours/
- https://decrypt.co/110023/ethereum-fork-ethpow-suffers-bridge-replay-exploit-token-tanks-37

SEC Crypto Asset Office – Sept 2022

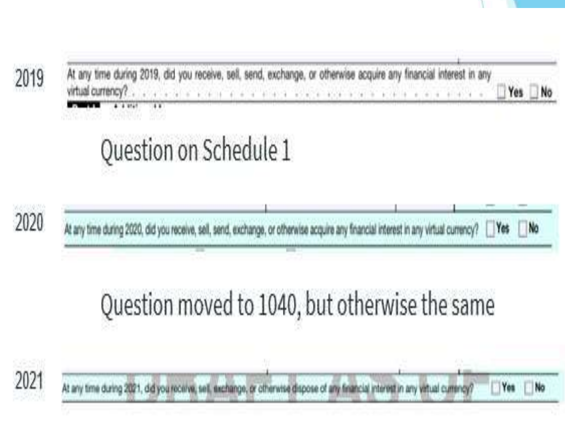
- Office of Crypto Assets will join the seven (7) existing offices that handle corporate disclosure filings
- https://www.reuters.com/markets/us/us-sec-set-up-new-office-crypto-filings-2022-09-09/
- *Office of Crypto Assets*
- The Office of Crypto Assets will continue the work currently performed across the DRP to review filings involving crypto assets. Assigning companies and filings to one office will enable the DRP to better focus its resources and expertise to address the unique and evolving filing review issues related to crypto assets.
- https://www.sec.gov/news/press-release/2022-158

Crypto Tax Focus

Everyone ready?

The 1040 Crypto Question

- Question about crypto involvement is still on the 1040, but now the language has been tweaked to include "disposed of" in the question itself
- Basically the question is now focusing on the transactions themselves versus the taxability of those transactions
- Transparency is key



FBAR requirement?

- FinCEN has been going back and forth on this issue, but what exactly are we talking about?
- No requirement to report crypto held in overseas wallets – at this time
- Lots of debate over
- 1) Whether crypto will have to be reported via an FBAR at all
- 2) What is the cut-off level for this reporting ($10,000, or something else)
- 3) Who has to report these items?
- https://tokentax.co/blog/how-to-file-a-crypto-fbar/
- https://www.natlawreview.com/article/fincen-seeks-to-establish-fbar-requirement-cryptocurrency-accounts-2021

What about FATCA? (Form 8938)

- What about it?
- Threshold for reporting (single filer) is if
- 1) total value of foreign assets exceed $50,000 as of last day of tax year
- 2) total value is above $75,000 at any point during the year
- You might have a FBAR filing requirement without FATCA, but if you file FATCA you are almost guaranteed to have an FBAR requirement
- As with everything else, a lot of uncertainty

Bipartisan Infrastructure Bill

- This bill passed in November 2021
- One minor clause now includes a change to how crypto is treated
  - Under this change, crypto is now treated as the equivalent as cash
  - Just for Section 6050I
- Any trade or business that receives $10,000 or more in physical currency (now including crypto) has significant reporting requirements
  - Including Form 8300
- All brokers will have to file 1099 and declarations
- https://www.wsj.com/articles/bitcoin-like-cash-crypto-currency-digital-assets-sect-60501-tax-code-infrastructure-bill-mchenry-ryan-11642449658

But there is more

- Major concern was that miners, coders, stakers, and other developers would be lumped in as “brokers”
- Treasury came out (Spring 2022) and said that would not be the case
- No official ruling from the IRS as of yet
- https://www.theblockcrypto.com/post/134039/us-treasury-reiterates-that-the-irs-wont-consider-crypto-miners-stakers-or-coders-to-be-brokers
- Will also impact DeFi (more on that later)

Jarrett vs. United States

- Nothing has changed as a result of these headlines
- Trial itself is only scheduled for 2023
- Evidence gathering has just started (March 2022)
- No change to IRS guidance or FAQs
- No indication that policy changes are coming
- Conversation specific to the unique facts and circumstances of this case and complaints therein
- https://www.natlawreview.com/article/recent-tax-developments-concerning-staking-rewards

Reporting crypto taxable income

- Crypto income and earnings are taxable, no matter what reddit or Instagram experts say
- Capital gains and losses should be reported on form 8949
  - IRS cross checks disclosure question with form 8949
- Those gains/losses flow through to Schedule D
- Mining income is generally considered ordinary income
- Paying/being paid in crypto should be reported at FMV at the date of payment

Erroneous tax data

- Repurposing 1099-B's have been put forward as the solution to produce more crypto tax data
- Not a perfect solution
- Crypto exchanges do not always have basis data
- Interoperability and cross-chain applications can make traditional reporting more complicated
- https://www.coindesk.com/layer2/taxweek/2022/02/23/form-1099-b-is-not-the-solution-to-your-cryptocurrency-tax-problems/

Stablecoin

Are these taxable or what?

Stablecoin breakdown

- Have a market capitalization well in excess of $150 billion USD
- Used for transactional purposes, and play an integral role in the DeFi economic landscape
- Issued by private organizations and are pegged to external assets
  - Fiat currencies
  - External assets (gold/oil)
  - Other cryptocurrencies
- But, are they taxable?

Stablecoin taxes?

- Stablecoins are treated the exact same way as other cryptoassets
- When used for purchases or paying for goods and services these cryptoassets must be disclosed, reported, and have any applicable taxes paid based on these transactions
- Only primary upside is
  - Lack of volatility means the tax obligations will be limited
  - Authorization by major players means that reporting/disclosure is more consistent and understandable
- Who is involved?

Does this matter?

Cryptocurrency is talked about a lot, but does it actually matter for you and your clients

Now or in the future?

Yes!

Coinbase has 80 million users worldwide, with nearly 3 million trading daily

As per most recent filings

Do these sound familiar?

- PayPal – 361 million users
- Visa – over 1 billion accounts worldwide
- Mastercard – over 700 million accounts worldwide
- Venmo – over 50 million monthly users
- CashApp – over 30 million monthly users
- They all allow crypto transactions
- Does it matter now?

Decentralized Finance

What is DeFi?

- New name and term for what was called “open finance”
- An umbrella term for a suite of blockchain projects and initiatives
- Runs primarily on Ethereum or Ethereum-based blockchains
- Increased reliance on smart contracts
- Capitalization of DeFi market grown from $686 million in Jan 2020
- Over $15 billion in Jan 2021
- Still $170 billion by Q3 2022
- https://news.bitcoin.com/total-value-locked-in-defi-reaches-250-billion-uniswap-quickswap-trader-joe-dominate-dex-volumes/#:~:text=The%20total%20value%20locked%20(TVL)%20in%20defi%20has%20reached%20an,value%20has%20expanded%20by%2025%25.

DeFi applications

- Decentralized exchanges (DEX)
- Stablecoins
- Crypto lending programs
- Wrapped bitcoins
- Prediction markets
- Yield farming
- Liquidity mining
- Composability
- Money legos

DeFi Tax Focus

- Staking
- Block rewards
- DeFi lending and liquidity pools
- Wrapped tokens
- Crypto loans and borrowing

Staking

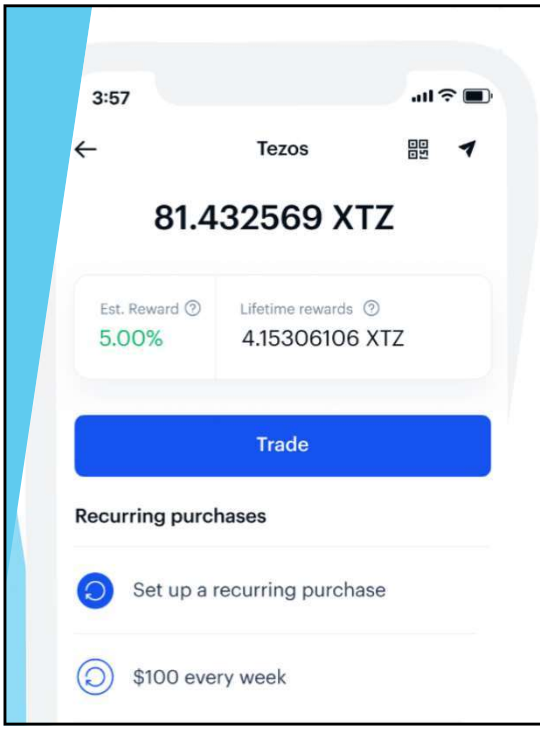
- Staking is a complicated issue that can vary depending on the investors and platforms involved
- Generally conducted as a way for investors to earn rewards for holding/investing into certain cryptocurrencies
- Crypto becomes part of a staking pool, and is utilized by the blockchain protocol for Proof-of-Stake consensus validation
- Allows taxpayers to earn crypto denominated income in a passive way
- Almost always involves a vesting or lock-up period where crypto is inaccessible

Staking taxes

- Is staking treated as ordinary income? No hard and fast answer as of yet
- Numerous lawsuits and arguments on this issue
  - Including the Jarrett v United States
- Congressional Blockchain Caucus also arguing for clearer and consistent regulation
- Also need to answer whether this meets the criteria of a trade or business?

Different crypto staking

- First question to ask is what kind of crypto staking arrangement is actually being used
  - Are the cryptos that are “locked” actually being used to validate transactions
  - Or is the arrangement move of a yield-generation one
- Actually running the node might be considered an active trade
  - Normally referred to as a validator versus a staker
- Delegated staking (usual type) is unlikely to be active



How widespread is it?

- What are the odds you have clients that are involved in crypto staking?
- Is it easy to get involved or super complicated
- Easy to do on your phone

How to report staking income?

- No hard and fast guidance on these issues as of right now
- Best bet is to be transparent and consistent with regards to what is reported and where it is reported
- Schedule 1 Line 8 is common location for reporting staking income
- Used as the catch-all for various types of other earnings, winnings, or types of income
- No predetermined home for staking income at the IRS

Wrapped tokens

What??

What is a wrapped token?

CoinDesk

Ethereum $2,489.84 -5.29% XRP $0.719910 -2.94% Terra $76.78

Trying to trade bitcoin on the Ethereum blockchain is a little like trying to get a PC game to run on a Mac – it won't work unless you install special software. Thankfully, on blockchains, this process is rather simple thanks to something called a wrapped token. But what is a wrapped token exactly, and how does it work?

Put simply, a wrapped token is a token that represents a cryptocurrency from another blockchain or token standard and is worth the same as the original cryptocurrency. Unlike the original cryptocurrency, the wrapped token can be used on certain non-native blockchains and later redeemed for the original cryptocurrency.

One of the biggest benefits of wrapped tokens is they create greater interoperability between non-compatible cryptocurrencies and blockchains – opening the door for things like bitcoin lending or borrowing ether on DeFi platforms. This provides greater liquidity to decentralized services and boosts the utility of crypto assets.

- https://www.coindesk.com/learn/what-are-wrapped-tokens/#:~:text=Put%20simply%2C%20a%20wrapped%20token,redeemed%20for%20the%20original%20cryptocurrency.
- But what does this actually mean?

Implications of wrapped tokens

- Bitcoin is the largest and most well-known blockchain protocol and platform, but is not the most robust or even widely developed
- Ethereum and ERC-20 tokens are popular for
  - Smart contracts
  - NFTs
  - Decentralized finance
- Wrapped tokens allow holders of bitcoin (for out example) to obtain functionality on this more widely developed blockchain
- Cool, but what about taxes???

Quick take on wrapping bitcoin

- Wrapped bitcoin (wBTC) is most popular wrapped token currently
  - Well over $10 billion
- Wrapping bitcoin involves the following steps
  - Own bitcoin (obviously)
  - Find a wBTC provider
  - Merchant sends BTC to a custodian who mints your wBTC and holds your BTC
  - Can be redeemed, and wBTC is destroyed when BTC is returned to you
- Maintains the constant level of BTC (21 million hard cap)
- Allows BTC holders to monetize crypto holdings

Taxes on wrapped tokens

- Wrapped tokens are treated the same as other virtual or digital currencies under current IRS guidance
- Ordinary income or capital gains treatment
- Same disclosure and reporting rules apply
- Earnings denominated in crypto usually reported at FMV at the date they are earned
  - Open to debate
- Question also includes whether wrapping the token represents a crypto-to-crypto swap (taxable), or just holding the same asset with a different name (non-taxable)

Bridged crypto?

How Do Blockchain Bridges Work?

Blockchain bridges can do a lot of cool stuff like converting smart contracts and sending data, but the most common utility is token transfer. For example, bitcoin and Ethereum are the two largest cryptocurrency networks and have vastly different rules and protocols. Through a blockchain bridge, bitcoin users can transfer their coins to Ethereum and do with them what they otherwise could not on the bitcoin blockchain. That can include purchasing various Ethereum tokens or making low-fee payments.

When you have bitcoin and want to transfer some of it to Ethereum, the blockchain bridge will hold your coin and create equivalents in ETH for you to use. None of the crypto involved actually moves anywhere. Rather, the amount of BTC you want to transfer gets locked in a smart contract while you gain access to an equal amount of ETH. When you want to convert back to BTC, the ETH you had or whatever's left of it will get burned and an equal amount of BTC goes back to your wallet.

If you would do this regularly, you'd have to convert bitcoin to ETH on a trading platform, withdraw it to a wallet then deposit again to another exchange. By the time it gets there, you'd have incurred more fees than probably what you planned to do in the first place.

- Think of it like how PayPal can be used to pay for almost every online transaction
- Another attempt to approve the interoperability around blockchain and cryptoassets
- Is this taxable?
- https://blog.liquid.com/blockchain-cross-chain-bridge#HowDoBlockchainBridgesWork

Non-fungible token focus

First things first

- In order to purchase an NFT the vast majority of these tokens can only be purchased with ETH
- So in order to even buy an NFT in the first place (more on that in a second)
- Investors/customers need to have access to crypto in the first place
- Potential doubling of taxable and reportable events

NFT, explained

- Digital assets that are connected and represent an underlying asset
- Every NFT contains distinctive and identifiable information that makes it distinct from any other NFT
- Cannot be exchanges directly for each other
- Cannot be sub-divided like bitcoin can be sub-divided in Satoshi's
- Reduces the potential for fakes/forgeries due to blockchain foundation

NFT License

- Put forward by Dapper Labs
- Contract template that can be customized to specify what rights are conveyed
- Distinguishes the NFT from the underlying art or asset
- Clarifies that the NFT holder obtains a 1) personal license to use and display the art, and 2) a commercial license to merchandise and monetize the asset
  - $100,000 gross revenue limit
- Just one example

NFT Tax Treatment

Might be a bit different from other crypto taxes, which create a taxable event every time there is a transaction involving these digital assets

Since NFTs are just digital representations of physical assets, like real estate, would the tax treatment simply mirror the tax treatment of the underlying asset?

No definitive guidance on accounting, but income streams are possible depending on the use case…

NFT tax options?

- Non-fungible tokens (NFTs) can be taxed in variety of ways
  - Ordinary income for minters/creators or taxpayers who create them
  - Can also generate capital gains if held for over 12-month period
  - Might also be taxed at collectible rate if certain conditions apply
- Generally reported on form 8949
- Key point to remember is that not all NFTs are art
  - Either by definition
  - IRS classification

What is art?

(2) Collectible defined

For purposes of this subsection, the term "collectible" means—

(A) any work of art,

(B) any rug or antique,

(C) any metal or gem,

(D) any stamp or coin,

(E) any alcoholic beverage, or

(F) any other tangible personal property specified by the Secretary for purposes of this subsection.

FAQ #1 - How are NFTs different from other cryptoassets?

- The primary difference between NFTs and other cryptoassets can be boiled down to two facts. Firstly, NFTs are unique and distinct assets, so this means that that they cannot be exchanged for one another like bitcoin and other cryptocurrencies can be. Secondly, and since these cryptoassets represent distinct claims linked to assets, NFTs cannot be subdivided and used fractionally as a currency equivalent.

FAQ #2 - What is the accounting treatment for NFTs?

- Since there is no crypto-specific authoritative accounting guidance in the marketplace, the general rule is that cryptoassets are treated as the equivalent to indefinite lived intangible assets. That said, and something we will be exploring in more detail, depending on the underlying asset in question - as well as the process by which these NFTs are issued - the accounting treatment will change.

FAQ #3 - Is there a tax implication for NFTs?

- Generally speaking NFTs are taxed as property, which all cryptocurrency are treated and taxed as. Where the differentiation comes into play is whether or not a taxpayer is an NFT creator, or is simply buying and selling NFTs. Creators are taxed at the point in time that the NFT is sold, with any income being recognized as ordinary income. Buyers and sellers of NFTs are going to be taxed similar to how other cryptocurrencies are taxed, with long term capital gains rates, or short term (ordinary income) rates coming into play.

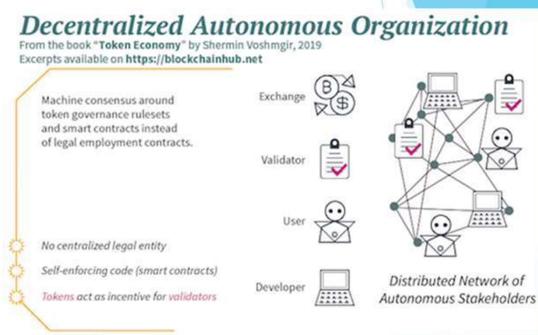
DAO Drilldown

What is a DAO

- A decentralized autonomous organization is a blockchain-based cooperative that is collectively owned by its members, with rules set and executed through code. DAOs replace centralized management structures with a techno-democratic approach wherein decisions are voted upon by investor-stakeholders. DAOs are built on top of blockchains (often Ethereum) and their transactions are visible on the underlying blockchain protocol.
- https://www.gemini.com/cryptopedia/the-dao-hack-makerdao#section-what-is-a-dao
- Decentralized, automated, and transparent
- Raises numerous tax issues based on how it is structured

Decisions are voted upon by investor-stakeholders

Driven by the issuance and holding of governance tokens



DAO Governance Highlights

- DAOs can operate resembling more of a centralized organization or a traditional decentralized blockchain organization
- Centralized – more like an incumbent organization/firm
- Decentralized – tokens incentivize behavior
- If decentralized, primarily governed by smart contracts
  - Executable programmable code embedded into an underlying blockchain

Big picture issues?

- Can taxes be assessed on a DAO?
- If yes, how are those taxes paid and who pays them?
- Are payments from the DAO taxable?
- Is the receipt of governance tokens taxable?

Can taxes be assessed on a DAO

- The short answer is probably yes
- No definitive IRS DAO-specific guidance of this presentation
- Let’s look at the criteria to determine whether an entity is taxable entity or not
- Entities are generally considered taxable when partners agree to work together and divide profits
- Sounds a lot like the smart contract driven governance of a DAO

- If a DAO earns profits from fees, investment strategies or other activities which individual or entity is liable?
- No clear cut guidance in the marketplace as of yet?
- Would every wallet-holder be liable for a proportional share of the income/earning of the DAO?
- OR, would the current IRS model for pass-through entities be followed?
- Taxes to be paid by the managing/members

Who pays these taxes?

Are payments from DAOs taxable?

- Yes
- Payments made from DAO controlled ETH-wallets are taxable income to those individuals/institutions that receive them
- If a user/investor funds a project, and receives a deposit from the associated DAO
  - Governed by a smart contract
- Those funds must be reported and will be subject to income taxes

Governance tokens

- What are governance tokens?
- Tokens distributed to users/managers/investors as part of a launch or as an incentive for activity on a certain protocol
- The receipt any token will generate a tax reporting and tax payment liability for the individual or institution

DAO Tax Summary

- No DAO-specific tax guidance as of yet
- DAOs could technically be classified, and have been, as taxable entities
- Assessing and collecting DAO taxes remains an open issue
- Receiving of tokens/payments from the DAO generates a tax reporting and payment item for individuals and institutions
- Contributing capital does not generate taxable events

First things first

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Crypto Tax Planning

Qualified opportunity funds

Qualified opportunity fund

- Sec 1031 exchanges are not able to be made with cryptocurrency, BUT selling the cryptoassets and investing the gains with proceeds in a Sec. 1400Z-2(d) qualified opportunity fund (QOF) allows this divestment while allowing access to original cost basis
- Also can defer the recognition of capital gains
- Holds investments in QOF for 5 years, 10% exclusion from gross income
- 7 years, 15% exclusion from gross income
- 10 years, 100% exclusion of appreciation from gross income

Example of offering

- Not affiliated with this organization, so be sure to perform your own due diligence
- https://bitcapital.fund/opportunity-zones/
- Solid tax article explaining the benefits
- https://bitcapital.fund/opportunity-zones/
- Frequently asked questions about QOFs
- https://www.ictsd.org/is-a-qof-partnership-considered-a-security/

Corporate Transparency Act

What is the CTA?

- Corporate Transparency Act written as part of the Anti-Money Laundering Act (2020)
- Public comments had closed during February 2022
- No effective date as of yet
- What are the reporting requirements of this bill?
- https://www.natlawreview.com/article/what-emerging-growth-companies-and-investors-need-to-know-about-corporate

CTA reporting

- Requires that domestic and foreign "reporting companies"
  - Report certain identifying information concerning "beneficial owners"
  - Major equity owners
  - Managers
  - Directors
  - Senior officers
  - To FinCEN
- Failure to report can result in stiff penalties, including a $500 per day fine

CTA exclusions

- The CTA might seem like a blanket reporting requirement, but there are exempt entities
  - Certain publicly-traded entities
  - Banks
  - Large operating entities that filed a tax return showing revenue in excess of US $5 million per year, have over 20 FTEs, and physical operate in the U.S.
- Many crypto organizations would **not** be exempt from these reporting requirements
- What could this mean for the sector?

CTA intro wrap-up

- The CTA as currently written could create an onerous and crippling reporting requirement for crypto organizations
- Who is responsible for identifying the “beneficial owners?”
- What about DAOs?
- What about decentralized protocols, smart contracts, or other crypto-applications?

Thank you!

- Questions?
- Comments?
- Jokes?
- Twitter - @seansteinsmith
- LinkedIn – Sean Stein Smith