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Tax Law Struggles To Keep Pace With the Proliferation of Cryptocurrency

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Takeaways

- The technical architecture of various cryptocurrencies makes it difficult to bring them within existing tax rules, even those designed to deal more generally with the digital marketplace.
- The U.S., U.K. and Australia have started to offer guidance on topics such as the timing of income recognition and capital gains treatment.
- Because it is debatable where some crypto transactions occur for tax purposes, determining which jurisdiction has primary taxing authority is often unclear.
- Moves by regulators and tax authorities to tighten cryptocurrency regulation and require more reporting from exchanges and other financial institutions could cause some crypto activity to migrate to different jurisdictions, further complicating these tax issues.

As of December 2021, more than 15,500 cryptocurrencies and 445 digital asset exchanges existed (according to CoinMarketCap), and the global market cap of cryptocurrencies reached $2 trillion, rivaling the estimated $3 trillion in alternative assets under management globally.

As digital assets proliferate, so do questions about their taxation. Many rules designed over the last century to deal with financial and commercial assets — from derivatives to intellectual property — are ill-suited to the digital assets now being created, traded, lent and hypothecated.

A lack of international consistency compounds this problem. Even if one jurisdiction works out rules for, say, the timing of taxable events, those may not dovetail with other countries' approaches, and existing tax treaties are little help.

National tax authorities are forced to choose between supporting new legislation, which risks quick obsolescence, or stretching existing legislation — generally with administrative guidance under existing law — to cover cryptocurrencies. Neither approach is ideal.

We analyze some key tax questions below, along with a view on where authorities are likely to focus future efforts.

Are Cryptocurrencies Legal Tender for Tax Purposes?

Tax authorities are putting significant effort into disabusing taxpayers of the notion that income earned through cryptocurrencies is not taxable because it is just "exchanging cash."

Cryptocurrency has certain features of legal tender. The European Central Bank, for example, lists three defining characteristics: It can be used (1) as a medium of exchange to avoid barter, (2) as a unit of account to simplify the measurement of value and costs, and (3) to store value for future saving and retrieval. Some cryptocurrencies may check all three of these boxes.

Yet tax authorities increasingly hold the view that cryptocurrencies are not legal tender, but rather a distinct property asset. In the U.S., the Internal Revenue Service (IRS) characterizes cryptocurrency as property that is not currency. The IRS's characterization is apparently intended to apply even to stablecoins, for which this treatment may be more questionable (particularly, for example, for stablecoins pegged to and backed by the U.S. dollar).

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When Does a Taxable Realization Event Occur?

Two primary taxable events are when cryptocurrency is:

- “mined” or otherwise initially created or distributed, including via an “airdrop” (a free, often promotional distribution) or “fork” (a change in a cryptocurrency’s blockchain protocol, potentially converting it to two new chains); and
- sold, exchanged or otherwise disposed of.

Mining

Mining is essentially the creation of a digital asset through application of computing power. Mining has attracted some detailed attention from tax policymakers.

In informal guidance, the IRS has stated that, when a taxpayer mines cryptocurrency, its fair market value on the date of receipt is included in the taxpayer’s gross income. If the mining occurs as part of an individual taxpayer’s trade or business (and is not undertaken by the taxpayer as an employee), the income (less allowable deductions) is also subject to self-employment tax.

In the U.K., HM Revenue and Customs (HMRC) states that it treats each situation on a case-by-case basis. For example, using a home computer while it has spare capacity to mine tokens would not normally amount to a trade. However, purchasing a bank of computers dedicated to mining tokens for an expected net profit (taking into account the cost of equipment and electricity) would probably constitute trading activity. If the mining activity does not amount to a trade, the pound sterling value (at the time of receipt) of any crypto assets awarded for successful mining will generally be taxable as miscellaneous income.

In Australia, if mining is carried out as a business activity, any cryptocurrency generated is treated as trading stock income, and changes in trading stock’s value are included in income. If the mining is not a business activity, the mined cryptocurrencies are taxed under capital gains rules on disposal. The Australian Tax Office has stated that the treatment of new cryptocurrency received through a fork will depend on whether it is held as an investment or in a business.

Disposal

Disposal of cryptocurrencies, or assets exchanged for crypto, is also getting attention from tax authorities.

According to the IRS, a U.S. taxpayer’s receipt of cryptocurrency will generally result in gross income on the date received, assuming it is gross income under general tax principles. Thus, the IRS’s view is that receiving cryptocurrency in return for other property, or vice versa, may trigger recognition of a gain or loss — either a capital gain or ordinary income, depending on the circumstances. In the U.S., when a taxpayer invests in cryptocurrency, it is generally treated as a capital asset, so gain or loss can be either short- or long-term. However, if it is not a capital asset in a particular taxpayer’s hands — for example, inventory and other property held mainly for sale to customers in a trade or business — the sale or exchange can result in ordinary income. In addition, at least certain digital assets could be subject to “mark to market” taxation for taxpayers trading or dealing in those assets and otherwise subject to Internal Revenue Code §475.

The U.K. distinguishes between investing and trading, particularly when it involves the value of losses from commercial activity. To date, HMRC has been reluctant to confer the title of “trading” on digital assets activity, for fear of allowing individuals who generate significant losses to offset other income. In guidance, HMRC has therefore focused on the capital gains treatment of profits from the sale of digital assets.

In common with other authorities, the U.K. acknowledges that calculating the basis can be difficult, particularly for crypto assets created rather than acquired.

Do Tax Exemptions for Foreign Investments in Pooled Investments Apply When Funds Invest in Digital Assets?

Both the U.S. and U.K. offer tax exemptions for foreigners investing through asset managers based in those countries.

In the U.S., a safe harbor applies to nonresidents trading stocks, securities or commodities through U.S.-based agents. Digital assets have raised several questions here. One example: Is a foreign miner using U.S.-based servers, custodians, software or personnel a “dealer,” not a trader, and thus outside the scope of the exemption? Second, for traders, are the digital assets “stocks,” “securities” or “commodities” within the meaning of the statute? It may be difficult to cast typical cryptocurrencies like bitcoin or ether as “stocks” or “securities,” but they may be “commodities.” Status as a “commodity” for this purpose depends on whether the cryptocurrency, or derivatives on that cryptocurrency, are traded on an “organized commodity exchange.” It seems the IRS is still considering this point.

The U.K. has a similar regime, called the “investment manager exemption.” The asset management industry tried unsuccessfully to convince HMRC three years ago that existing legislation sufficiently covered many of the more commonly traded digital assets. A process is now underway to define “digital assets” for the purposes of offshore funds trading through a U.K. investment manager.

Where Are the Assets, and Where Is the Taxable Commercial Activity?

Tax authorities face serious obstacles claiming jurisdiction over digital asset activity. Is the source of income

determined by the location of personnel or hardware, or where relevant software is produced or updated? This is particularly difficult in a world of the distributed ledger. But the answer could be critical to establishing the existence of branches or permanent establishments under tax treaties, and, consequently, which country has a primary right to tax.

The issue also arises with digital asset exchanges, some of which claim to have no location. Such exchanges and their participants must consider where the fees from their activities are earned, and manage the potential risk that parties with which they interact may develop a taxable branch or permanent establishment relationship.

Additional Trends To Watch

A number of other potential developments could present challenging tax issues and affect the market for digital assets.

- **Shying away from the U.S.** As the Securities and Exchange Commission increases digital asset scrutiny, some exchanges and other market participants are looking to sever links with the U.S., including by removing U.S.-connected clients or counterparties from their platforms. New trading structures will be required to allow U.S. capital to be deployed in such trading while still respecting U.S. regulatory scoping rules.
- **Information reporting.** Digital transactions can be inherently hard to track, including identifying the true parties to the transaction. Third-party information reporting may be difficult or prohibitively burdensome for some cryptocurrency issuers or exchanges to administer. But both the U.S. and the Organisation for Economic Co-operation and Development (OECD) are addressing this issue.
  - **Broad enforcement actions.** A California district court in 2021 authorized IRS summonses to a cryptocurrency exchange to obtain a list of users involved in $20,000 or more of cryptocurrency transactions from 2016-21. Other exchanges have received similarly broad requests for transaction information. The IRS used that information to send mass-mailed letters to taxpayers with crypto transactions who the IRS believed potentially did not report certain income.
  - **Statutory information reporting.** The U.S. Treasury announced in this year's Green Book a proposed financial accounting regime aimed at cryptocurrency exchanges and wallets, large parts of which were included in the recently enacted infrastructure bill. These provisions will apply to tax returns and statements due after December 31, 2023.
  - **IRS regulatory efforts.** The IRS' "priority guidance plan" includes proposed regulations on broker reporting for cryptocurrency assets, and we understand that the IRS has been working on those proposed regulations while watching legislative developments. Our assumption is that, to the extent they were drafted prior to passage of the infrastructure bill, those proposed regulations will be converted to guidance under the bill's new statutory provisions on broker reporting. Bloomberg reported January 7 that the Treasury Department plans to issue guidance by the end of the month, in advance of the regulations, indicating which types of firms will be "brokers" subject to reporting obligations.
  - **OECD action.** In a similar vein, the OECD, whose Common Reporting Standards set requirements for financial institutions and provide for the sharing of that information across jurisdictions, is expected to issue specific guidelines for cryptocurrencies soon.
- **Cryptocurrencies can require the coordinated operation of multiple computer systems**. Questions will arise about the jurisdictions in which these collaborations are deemed to operate, creating potential compliance headaches for tax directors.

Conclusion

Without a doubt, tax authorities are getting more focused on digital assets. Compliance will increase, as will the complexity of the rules. The earlier era of less restricted commercial activity, uncovered by specific rules, is fading, at least in certain jurisdictions. Corporate participants in the digital asset market need to manage tax risk by building their internal support teams to comply with tax and reporting matters and closely tracking new legal developments. Participants should also be prepared to be flexible on where they establish their relevant structures globally, as the distributed nature of the digital asset market will encourage innovative thinking from a jurisdictional perspective, not least from the regulators and tax authorities.