September 8, 2023

The Honorable Ron Wyden, Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Mike Crapo, Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

RE: Digital Assets Taxation

Dear Chairman Wyden and Ranking Member Crapo:

In response to the July 11, 2023 Senate Finance Committee letter inviting comments from the digital asset community and other interested parties to help Congress better understand how to address the tax challenges and opportunities presented by digital assets, the American Institute of CPAs (AICPA) is providing the enclosed comments that were developed by our AICPA Virtual Currency and Digital Assets Tax Task Force. We are not addressing all the questions in the Senate Finance Committee letter and have not listed those we are not addressing.

The AICPA is the world's largest member association representing the accounting profession, with more than 421,000 members in 128 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Annette Nellen, Chair, AICPA Virtual Currency and Digital Assets Tax Task Force, at (408) 924-3508 or Annette.Nellen@sjsu.edu; Reema Patel, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9217 or Reema.Patel@aicpa-cima.com; Lauren Pfingstag, Director – AICPA Congressional and Political Affairs, at (202) 434-9208 or Lauren.Pfingstag@aicpa-cima.com; or me at (830) 372-9692 or bvickers@alamo-group.com.

Sincerely,

Blake Vickers, CPA, CGMA
Chair, AICPA Tax Executive Committee

cc: The Honorable Kirsten Gillibrand
The Honorable Cynthia Lummis
Mr. Thomas Barthold, Chief of Staff, Joint Committee on Taxation
The Honorable Lily Batchelder, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Daniel I. Werfel, Commissioner, Internal Revenue Service
Mr. William M. Paul, Principal Deputy Chief Counsel, Internal Revenue Service

AMERICAN INSTITUTE OF CPAs

Comments on Digital Assets Taxation

September 8, 2023

Marking-to-Market for Traders and Dealers (IRC Section 475)

- *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))?*

Current law requires dealers in securities to use mark to market method for both inventory and non-inventory items; and allows traders in securities or commodities and dealers in commodity to elect to use mark to market method. We recommend Congress amend section[1] 475 to require a dealer of digital assets to use the mark to market method for income tax reporting purposes. Traders of digital assets should be allowed to elect to use the mark to market method to report their income.

Given the trading volume of digital assets, it is clear that digital assets have become a separate and distinct asset group. The current definition of "securities" and "commodities" do not describe digital assets exactly even though there are some similarities in each classification. We believe only a subset of "digital asset" will be eligible for section 475. Section 6045(g)(3)(D) provides a general definition of "digital asset."[2] We recommend Congress consider adding more specific definitions to provide guidance on which type of "digital asset" will fit under section 475. We note that current Treas. Reg. § 1.1092(d)-1 provides definition for "actively traded" and "established financial market" for straddle transaction purposes. We believe Congress can review what is currently being used in the Regulation to further develop or modify it to fit digital assets subject to section 475.

We recommend Congress to require dealers of digital assets to use mark to market method to report their activities during the year since mark to market method clearly reflects a dealers' trade or business in buying and selling digital asset in the ordinary course of a trade or business. Currently, section 475(c)(1) provides a definition for "dealer in securities," we recommend Congress to review the current section 475(c)(1) definition and consider adding a paragraph defining "dealer in digital asset" for section 475 purposes.

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[1] Unless otherwise indicated, all references to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), and references to a "Treas. Reg. §" are to the Treasury regulations promulgated under the Code.

[2] Section 6045(g)(3)(D) – DIGITAL ASSET – Except as otherwise provided by the Secretary, the term "digital asset" means any digital representation of value which is recorded on a cryptographically secured distributed leger or any similar technology as specified by the Secretary.

Traders of digital assets should be allowed to use mark to market method, similar to the election currently allowed for traders for "securities" and "commodities."

Our recommendation of expanding section 475 to include specific types of "digital asset" is in line with the current proposed Lummis-Gillibrand Responsible Financial Innovation Act (S. 2281, 118th Congress)[3] and the Administration's Fiscal Year 2024 Revenue Proposals.[4]

Trading Safe Harbor (IRC Section 864(b)(2))

- *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?*

We recommend Congress consider adding a new safe harbor similar to the section 864(b)(2)(A) and 864(b)(2)(B) safe harbor for a subset of digital assets which are eligible under section 864. We believe that in doing so, it will not only encourage foreign investment in U.S. investment assets; but also provide clear guidance for foreign investors and investment advisors to understand whether their trading activities within the U.S. constitute a U.S. trade or business.

Similar to our response in section 475 above, we believe a definition of a subset of digital assets should be developed and referenced for both section 475 and section 864 as not all digital assets have similar characteristics to the securities and commodities being traded on an exchange and currently included in the trading safe harbor under section 864(b)(2). For example, a non-fungible token (NFT) might be a type of digital asset; however, with the flexibility and creativity in the design of this type of token, an NFT can also represent "collectibles", "right to use", or "fractional ownership" to certain underlying properties. It may create more complexity if NFTs are included in the safe harbor exemption.

As we stated in our response to section 475 comments, we recommend Congress to review the current definition under Treas. Reg. § 1.1092-(d)-1 for "actively traded" and "established financial market" and consider adding a new section defining a subset of digital assets that will fit under

[3] Sec. 806(a), Lummis-Gillibrand Responsible Financial Innovation Act.
[4] General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals, p.202.

both section 475 and section 864. We do not believe Congress should use the current "securities" and/ or "commodities" definition to bring in all digital assets.

The Lummis-Gillibrand Responsible Financial Innovation Act (S. 2281, 118th Congress) recommends the modification of section 864(b)(2) to include certain digital assets. The current proposed bill takes a similar approach by defining "crypto assets" and "crypto asset exchange", then limiting the trading safe harbor to "a kind customarily dealt in on a crypto asset exchange and if the transaction is of a kind customarily consummated at such exchange."[5] We concur with the approach and the limitation proposed.

Treatment of Loans of Digital Assets (IRC Section 1058)

- *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.*

There are many different types of digital asset loans, in a broad sense, we can probably categorize them into three major categories:

- Taxpayer lends their own digital assets to another taxpayer or organization;
- Taxpayer borrows against their own digital assets; and
- Taxpayer borrows digital assets from another taxpayer or organization.

Currently section 1058 provides nonrecognition treatment for lending activities involving securities if certain requirements are met. This allows taxpayer and tax authorities to identify transactions and apply the proper tax treatment and allows the lender and borrower to follow formal guidance to set up proper agreements.

With more and more digital assets lending activities evolving in the past few years, we recommend Congress to amend section 1058 to include digital assets in the nonrecognition treatment of such section. We also recommend Congress to provide a clear definition of digital assets for section 1058 purposes. We believe only a subset of digital assets will be eligible for this nonrecognition

[5] Sec. 803(a)(C)(iv), Lummis-Gillibrand Responsible Financial Innovation Act.

treatment, most likely, those digital assets actively traded on an exchange. Please refer to our comments in response to section 475 above regarding adding definition to the legislation to provide clarity.

In addition, because it is a nonrecognition event, the economic position of the taxpayer with respect to the digital assets loaned should remain the same before and after the lending transaction. The taxpayer who loaned the digital assets is considered the owner of the digital assets, therefore when there is a hard fork, protocol change, or air drop, the taxpayer who is the owner of such digital assets should recognize income. The question is when does income recognition occur – at the time the taxpayer has the right to access the digital assets, or takes action to access the asset, or at the time the hard fork, protocol change, or air drop occurs?

The Administration's Fiscal Year 2024 Revenue Proposals and the current proposed Lummis-Gillibrand Responsible Financial Innovation Act both recommend amending section 1058 to include digital assets.[6]

Wash Sales (IRC Section 1091)

- *In what situations do taxpayers take the position that economic substance (IRC Section 7701(o)) applies to wash sales with regards to digital assets?*
- *Should IRC Section 1091 apply to digital assets? Why or why not?*

The longstanding wash sale loss disallowance/deferral rule of section 1091 only applies to investments in securities. Section 1091 does not apply to cryptocurrency or other digital assets. However, it is not clear if the economic substance doctrine applies to certain dispositions where an argument can be made that the taxpayer's position did not change. For example, assume an individual holding cryptocurrency for investment sells 100 of X coin in the morning realizing a loss and later that day buys 100 of X coin. The taxpayer's position at the end of the day is just like the day before: they own 100 X coin.

It is not clear under the economic substance doctrine when a sale at a loss and a repurchase should be viewed as lacking economic substance. For example, will it matter if a different quantity of the disposed of coin is acquired? Does it matter how long the taxpayer waits to make the repurchase? There are currently two proposals to expand the wash sale rule at section 1091 to include digital assets:

- Sec. 805 of S. 2281, Lummis-Gillibrand Responsible Financial Innovation Act which applies to "crypto assets" as defined in this bill, with some exceptions.
- Administration's Fiscal Year 2024 Revenue Proposals which includes a proposal to apply the wash sale rules to digital assets and related party transactions.[7]

[6] General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals, pages.193-196, and Sec. 804(d), Lummis-Gillibrand Responsible Financial Innovation Act.
[7] General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals, pages 190-192.

Should either of these proposals or something similar be added, we suggest the change consider the following:

- Dealer dispositions and use of assets for ordinary business transactions be excepted.
- The existing provision in section 1091 that wash sale potentially only applies where a taxpayer acquires the asset "by purchase or by an exchange" be continued so that digital assets acquired by mining or staking or other consensus protocol would not trigger the wash sale rule.

Timing and Source of Income Earned from Staking and Mining

- *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 provide feedback on the Biden Administration's proposal to impose an excise tax on mining.*

The tax treatment for rewards generated from staking and mining of cryptocurrencies raises challenging questions due to the technology involved, the use of a decentralized system to generate the rewards, and valuation issues. We have not addressed all the questions posed by your letter, but instead make the following suggestions related to this topic and the need for clarification of the tax treatment.

1. A legislative solution is likely the best action to address the tax treatment of staking and mining rewards so that there is one treatment rather than challenges and inconsistencies in applying existing tax statutes, regulations, and doctrines.
2. The tax treatment should address the timing and character of any income from rewards. Also, for section 469 purposes, clarification is needed on whether the rewards should be treated as portfolio income or trade or business income (with existing section 469 rules applied to determine if the trade or business income is active or passive).
3. Existing definitions of "trade or business" should be used to determine if an individual involved with mining or staking is in a business (for example, uses at section 162 and section 199A as further defined by regulations and judicial decisions such as *Groetzinger*, 480 US 23 (1987)).
4. Required documentation of mining and staking activity should be specified.
5. A new excise tax on mining should not be pursued due to complexity of defining such tax and calculating the base.

Nonfunctional Currency (IRC Section 988(e))

- *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?*

A new exclusion should be added to the Internal Revenue Code that is similar in effect to section 988(e) that excludes gains realized from personal transactions involving foreign currency that may have changed in value from when the individual acquired it to the time they used it for a personal purchase.

Today, most individuals acquire and trade digital assets for investment or for business use. The use of digital assets to acquire personal use property or services is not common. However, an individual using a digital asset to buy coffee, vacation services or other personal purchases will likely have nominal gains (or losses, that are already unusable per section 165(c) since they are not from an investment or business use). Allowing the individual to exclude any gain of $200 or less from personal purchases made with digital assets (as defined at section 6045(g)) will be an administrative convenience for the individual, similar to the ease of compliance provided by section 988(e) exclusion for foreign currency which is also limited to a gain of $200 or less.[8]

The exclusion should be added to Subtitle A, Chapter 1, Subchapter B, Part III, items specifically excluded from gross income, rather than added at section 988 because cryptocurrency is not treated as a foreign currency.[9] The provision should be added as new section 139J. An example of this change is proposed in H.R. 6582 (117th Congress). This bill would exclude gain from disposition of virtual currency in personal transactions if the gain does not exceed $200. Similar to section 988(e) H.R. 6582 does not call for any adjustment for inflation. An aggregation rule should be considered as currently proposed in S. 2281, Lummis-Gillibrand Responsible Financial Innovation Act. It provides that "all sales or exchanges which are part of the same (or a series of related transactions) shall be treated as one sale or exchange."[10]

If taxpayers use an exchange/broker as defined under section 6045 for the purchase of a personal use item, the sales price and basis will be reported to the taxpayer and the IRS on the expected new Form 1099-DA. To make it relatively easy for the taxpayer to remove gains under a new section 139J, a specific code for the new exclusion can be used with the taxpayer using that code on Form

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[8] See AICPA Letters, "Comments on Notice 2014-21: Virtual Currency Guidance," June 10, 2016 and "Updated Comments on Notice 2014-21: Virtual Currency Guidance ," May 30, 2018.
[9] Notice 2014-21, modified by Notice 2023-34.
[10] Sec. 801(b)(2), Lummis-Gillibrand Responsible Financial Innovation Act.

8949, Sales and other Dispositions of Capital Assets, to remove the excluded gain if the gain from the personal use transaction was $200 or less.

Valuation and Substantiation (IRC Section 170)

- *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 substantiation rules under section 170(f)(11) should be modified to account for digital assets. As the AICPA has stated in the two previous comment letters,[11] and as the Joint Committee on Taxation points out in the "Selected Issues Regarding the Taxation of Digital Assets"[12] exceptions already exist for "readily valued property" such as publicly traded securities.[13]

The easiest solution to modifying the substantiation rules to account for digital assets is to include an exception to the qualified appraisal requirement under section 170(f)(11) for actively traded fungible digital assets.

Why should the substantiation rules be modified to account for digital assets? Section 170(f)(11) already excludes publicly traded securities because they are readily valued property. The rationale is that the prices for these publicly traded securities are available on established exchanges, thus not requiring a qualified appraisal. The same is true for most, if not all, types of actively traded fungible digital assets. That is, various exchanges publish the value of the digital asset on any given day. Thus, a taxpayer donating an actively traded fungible digital asset worth more than $5,000 should not have the requirement to obtain a qualified appraisal, provided the donor documents the transfer under the usual section 170(f) rules and maintains proof of the value of the actively traded fungible digital asset.

- *What are the characteristics of an exchange and the digital asset for which this exemption would appropriately apply and why?*
    - This modification should apply to actively traded fungible digital assets. Non-fungible tokens are more likely to not have an established liquid market and so the scope of the qualified appraisal exception should likely be limited to fungible tokens.
        - In determining the definition of "actively traded" for digital assets, Treas. Reg. § 1.1092(d)-1 can be used as an example of how the Internal Revenue Code defines actively traded as it pertains to securities. It is worth noting,

[11] See AICPA Letters, "Comments on Notice 2014-21: Virtual Currency Guidance," June 10, 2016 and "Updated Comments on Notice 2014-21: Virtual Currency Guidance ," May 30, 2018.
[12] See Selected Issues Regarding the Taxation of Digital Assets, Joint Committee on Taxation.
[13] Section 170(f)(11)(A)(ii)

the definition of "actively traded" under Treas. Reg. § 1.1092(d)-1, as it is currently written, does not neatly fit with digital assets due to the regulatory uncertainty with which digital asset exchanges need to register with the SEC, so a modified definition for digital assets should be considered. Perhaps the most simplified characteristic in determining if a digital asset is "actively traded" is listing on more than one centralized exchange where the exchange(s) are regulated in the U.S.

Other Possible Legislative Changes Related to Taxation of Digital Assets

Hard Forks: Revenue Ruling 2019-24 holds that a taxpayer has income when a cryptocurrency resulting from a hard fork is recorded on the distributed ledger. This ruling presumes that the taxpayer has dominion and control of the new currency when it is recorded on the distributed ledger. However, the taxpayer must take additional actions to access that new currency and for various reasons, may never access it. The better result and better interpretation of the dominion and control test is that until a taxpayer takes action to access the new currency, they do not have income.

Another possibility for tax treatment of a hard fork or similar unsolicited property from a cryptocurrency event is to allow treatment similar to what is allowed under section 83(b). We raised this idea in a 2020 comment letter to Treasury and the IRS about Rev. Rul. 2019-24. Our suggestion, which also describes the rationale, follows.[14]

Attempting to create a mechanism or a set of rules for price discovery or price allocation, which can only take place at a moment in time after a hard fork or chain split occurs, can create an undue burden for taxpayers and result in an unlimited number of approaches, inconsistently applied. Taxpayers could apply a range of reasonable approaches to determine a United States dollar ("USD") fair value for chain splits, airdrops, and giveaways. However, taxpayers should have consistent application from one virtual currency to the next as these practices can give rise to possible manipulation or difficulty in proving when dominion and control was exercised. An election similar to what is allowed under section 83(b) would offer taxpayers some flexibility while providing a method for consistent application with new virtual currency events. In addition, a notification would clearly identify a point in time when income (and the amount of income) is realized under section 61. If no notification is made, the holder reports ordinary income based on the disposition proceeds. If a notification is made, the taxpayer reports ordinary income based on value at the time the notification is made and capital gain or loss on subsequent disposition (assuming the asset is held for investment). This approach would help limit disputes between taxpayers and the IRS as to whether and how dominion and control was exercised (or not exercised) and when, and additional guidance would add clarity to the challenging situation of how to tax these virtual currency events.

[14] See AICPA Letter, "Comments on Revenue Ruling 2019-24, the New Question on Schedule 1 (Form 1040), and the Internal Revenue Service's Frequently Asked Questions on Virtual Currency Transactions," Feb. 28. 2020.

Worthless Asset Losses: Section 165(g) provides that worthless securities are treated as a loss from the sale or exchange of a capital asset on the last day of the tax year. Thus, a capital loss results. Generally, individuals may only use capital losses against capital gains plus up to $3,000 of ordinary income, with any excess capital loss carried forward. Without this provision, a worthless capital asset would generate an ordinary loss because a capital loss only results from the sale or exchange of a capital asset (per section 1222).

Today, the capital loss treatment for worthless securities is a better result than an ordinary loss because such ordinary loss is only allowed as a miscellaneous itemized deduction subject to the two-percent-of-AGI limitation (per sections 62, 63 and 67).[15] For a worthless capital asset other than a security as defined at section 165(g)(2), the result is that the loss is not allowed. For example, this is the result (no loss allowed) if a digital asset becomes worthless.

For assets held for investment and treated as capital assets under section 1221, it seems that gains and losses should be treated similarly. This is not the case today for digital assets. Consideration should be given to modifying section 165(g) to cover additional types of worthless capital assets such as digital assets held for investment.[16]

[15] See description in CCA 202302011 (Jan. 13, 2023) on the tax treatment of a worthless digital asset. The disallowance of the ordinary loss from worthless digital asset only applies for 2018 through 2025. In 2026 and beyond (assuming no extension of the existing disallowance of itemized deductions subject to the two-percent-of-AGI limit) many individuals will still not be allowed a loss for worthless digital assets either because they do not itemize deductions or their miscellaneous deductions do not exceed two percent of their AGI.
[16] The AICPA raised additional issues regarding the tax treatment of various losses from digital assets in a letter to the IRS and Treasury , "Guidance Needed on the Tax Treatment of Losses of Digital Assets," April 14, 2023.