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Tax Whitepaper

From: Coinbase

Subject: U.S. Taxation of Cryptocurrencies-- A Sensible Proposal For Tax Policy Guidance

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Tl;Dr The crypto ecosystem has enjoyed rapid growth and wide acceptance within the US and abroad. It also has engendered considerable concern among Congress, Treasury and the IRS regarding tax compliance, resulting in legislation and forthcoming regulations regarding information reporting But, there is a huge tax gap in mainstream tax policy for crypto, which hinders growth, liquidity and U.S leadership in the crypto economy. The lack of guidance on critical U.S. tax matters impedes expansion of these markets within the United States, creates incentives for users to transact on non-U.S. platforms and creates confusion as different market participants report identical items differently. The following Whitepaper provides a summary of open areas that call for active dialogue and collaboration with policy makers to clarify and properly tax participants in the crypto economy.

Overall Request: Creation of Crypto Tax Task Force

Congress should empower the Treasury Department to convene a digital asset task force, consisting of Treasury, IRS, and external industry experts to meet on a regular basis and provide timely recommendations and action steps within 6 months to clarify U.S. tax law applicable to cryptocurrency.

Specific Tax Guidance Priorities

1. Specific subcategories of “cryptocurrency” or “digital assets” should be identified and defined.

The term “digital asset” is a defined term in the U.S. tax code in the Infrastructure Bill and the Build Back Better Act – in each case, capturing “any digital representation of value.”

Cryptocurrency assets come in multiple "flavors," reflecting the usage for the asset (or platform), the regulatory context and the attributes of the coin/token. In general, U.S. tax principles attempt to characterize assets based on their function and attributes. For this reason, guidance is needed to assign particular crypto assets to a category for tax purposes that most resembles their character. This would contribute to reaching a tax result most appropriate to the function and use of such assets in the crypto economy.

These characterizations would be broken down by cryptocurrency "type" for U.S. tax purposes (for example, security, commodity, utility, currency, other property (e.g., NFTs)). Further, governance tokens may be characterized by the predominant function(s) they provide in the ecosystem (such as providing software as a service, as a medium for payment, etc). Consideration could be given to whether cryptocurrency ought to be treated as a foreign currency (contrary to current IRS guidance) where it has been adopted as legal tender of a sovereign jurisdiction.

2. Cryptocurrency lending should be treated similarly to securities lending under Section 1058.

Liquidity is critical to any properly functioning financial market. The ability to "lend" or make available for use assets held by long-term investors is critical in supporting market liquidity (particularly in less liquid coins and tokens). The lack of clear rules applicable to cryptocurrency lending, and the risk that lending could be treated as a deemed "sale" of the lent cryptocurrency, place a chilling effect on much needed market liquidity in the cryptocurrency market.

Congress faced a similar challenge in the 1970s, and enacted specific rules for securities lending transactions to provide lenders of securities certainty that properly structured securities loans did not trigger gain on such positions. Although such a position could be reached under a reasoned reading of currently applicable U.S. tax authorities, it is not free from doubt.

The recommendation is to: (i) apply non-recognition treatment to the lender of cryptocurrency in a manner similar to section 1058; (ii) treat the source of fees as based on the residency of the recipient (or provide a complete exemption to withholding, similar to interest payments); and (iii) extend the protections from the recognition of unrelated business taxable income ("UBTI") for income and gains derived from securities loans to cryptocurrency loans.

3. Information reporting should be introduced sensibly across Centralized Finance ("CeFI") and Decentralized Finance ("DeFI"), taking into account the balance between government and industry needs.

Historically, the IRS has relied on information reporting provided by third party market participants (brokers, middlemen, payors, etc.) to encourage voluntary tax compliance and to support audit activity in its absence.

Blockchain and similar technology fundamentally changes this paradigm, as transfers and payments are recorded to a decentralized public ledger, versus to the private ledger of a broker or middleman. Accordingly, much of the information the IRS would seek through traditional information reporting may be or could be made available on the public ledger itself.

For this reason, Congress and the Treasury Department ought to consider alternatives for account documentation beyond properly completed W-series forms (like Forms W-8 series and W-9). Further, given the use cases for cryptocurrency as a medium for payment, a consistent *de minimis* rule for Form 1099 reporting (for example, $600 similar to the 1099-MISC and the 1099-K) would reduce the compliance burden for participants and processing burden for the IRS. In DeFi specifically, reporting alternatives to the Form 1099 ought to be considered to address that market participants may not possess (or be able to solicit and receive) full tax documentation for participants and recipients.

New technologies in crypto can be used to facilitate tax reporting and collections, including the use of identification tokens and smart contracts to collection information for limited governmental purposes and./or to impose and collect transaction level taxes. These new technologies would complement or replace the current process of tax reporting by identifying the taxpayer through the use of their Taxpayer Identification Number (TIN). Taxpayers prefer simplicity and finality– a new tax reporting and compliance framework that attributes tax residency and provides immediate tax identity to taxing authorities will enhance tax compliance and ease anxiety among crypto market participants about running afoul of tax laws. Sales and other transactional taxes can be collected and remitted upfront. Income taxes can be collected and withheld pending final determination of tax liabilities similar to the existing but cumbersome withholding tax framework.

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4. Stablecoins should be excluded from information reporting

Stablecoins, by definition, are intended to retain their value by being "pegged" to an existing financial asset (like the U.S. dollar or gold). This "peg" is achieved through a variety of means (such as supporting a redemption right through reserve accounts, or through an algorithm based on the underlying value of other cryptocurrencies. For this reason, information reporting on the gross proceeds of the disposition of such coins is expected information of minimal value, as the gains in such assets are minimal or zero.

For this reason, the recommendation is to exclude stablecoin transactions from U.S. tax information reporting because such reporting is both operationally burdensome and expected to yield minimal (if any) otherwise unreported gains. Such an exception is quite similar to the current exception from gross proceeds reporting for non-transferable bank deposits and, therefore, consistent with existing tax policy in traditional finance.

5. Source and timing of staking rewards should be defined.

Environmental considerations and practical restraints have supported a consistent move within the cryptocurrency ecosystem from proof of work networks (like Bitcoin) to proof of stake network (like Solana and Ethereum 2.0). Proof of stake ecosystems require fewer environmental resources and process transactions faster than proof of work networks.

Having owners of tokens in such ecosystems make their coins/tokens available to stake is critical to drive processing speed and availability (and diversity) of validators. Investors with certain tax attributes (such as tax-exempt and non-U.S. investors) may be wary of staking their tokens out of a concern about U.S. tax imposed on the passive income earned from making their tokens available to stake.

The recommendation is to provide guidance treating any staking reward as sourced based on the residency of the recipient. While sourcing to the residency of the recipient would be the best option for staking rewards, if sourcing is determined differently, then it is also requested that further guidance is provided as to the treatment of cryptocurrencies within the framework of U.S. income tax treaties. For example, if staking rewards paid to a non-U.S. recipient are considered U.S. source then the non-U.S. recipient should be able to claim treaty benefits on such income. Further, such guidance should clarify that staking rewards are treated similar to other kinds of portfolio income (like interest or dividends), such that the rewards do not

represent unrelated business taxable income ("UBTI") or income from the conduct of a U.S. trade or business. Further, the timing for the recognition income for staking rewards should be clarified, taking into account the limitation on receipt for such rewards in certain protocols.

6. Charitable Donations of Cryptocurrency should be encouraged.

Charitable donations of all kinds ought to be encouraged to assist these organizations to further their exempt purposes. A study from Fidelity found that holders of cryptocurrency are disproportionately more charitable as investors, with 45 percent donating $1,000 or more to charity in 2020, compared to 33 percent of the entire investor population. This aligns with the demographic ownership of cryptocurrency: Millennials and Gen Z investors are more likely to hold cryptocurrency and are more inclined to mark charitable deductions.

The recommendation is to (i) treat cryptocurrency like publicly-traded stock where a donation to a private foundation of long-term gain property would permit contributor to a charitable deduction for the full fair market value at the time of the donation; and (ii) eliminate requirement to seek appraisal for a readily-tradable cryptocurrency. To eliminate barriers to receiving such donations on the exempt organization side, the recommendation is to clarify that income related to cryptocurrency (lending and staking) is neither UBTI nor income that is subject to the prohibited transactions tax for private foundations.

7. U.S. Trade or Business Treatment for Non-U.S. Traders in Cryptocurrency should be symmetrical with securities and commodities.

Current law excludes from the U.S. tax on income "effectively connected" to a U.S. trade or business income from trading in securities and commodities. The current law safe harbor covers certain cryptocurrencies today (based on trading market and regulatory status in the U.S.), but not all cryptocurrencies.

The recommendation is to apply the section 864(b) safe harbors to non-U.S. trading in all cryptocurrencies, regardless of whether they constitute securities or commodities or other types of property.

8. De Minimis gains should be excluded from tax similar to foreign currency

Current law excludes from tax de minimis gains from foreign currency held for personal use (for example, Euros brought back from a European vacation). The basis for such exclusion is administrative (large tax filing / calculation burdens for minimal tax revenue).

As mainstream adoption of cryptocurrency as a medium for payment (similar to foreign currency), a *de minimis* rule ought to be provided to exclude gains on an annual basis up to a certain minimal threshold (e.g., $600). The amount of tax revenue impacted from such a provision is minimal, and the elimination of the need for reporting supports the adoption of various cryptocurrencies in payment use cases.

9. Tax treatment of DAOs should be clarified

Decentralized Autonomous Organizations (“DAOs”) form the backbone of many cryptocurrency ecosystems. DAOs are intended to automate the management of a particular blockchain ecosystem, reducing the risk of human error and using consensus to manage the risk posed by large investors controlling a particular market. DAOs lack a juridical entity, centralized management or other hallmarks of a traditional business entity.

The recommendation is that it should be clarified when DAOs rise to the level of a business entity. Further, if some or all DAOs were to be considered business entities, clear guidance should be provided on how to determine whether a DAO should be classified as a business entity, how its jurisdiction of residence (as domestic or foreign) is determined, and how it can comply with information reporting and tax paying requirements.

10. Tax treatment of non-fungible tokens (“NFT”) should be clarified

The NFT market has exploded in 2021, with sales of NFTs surging to $10.7 billion in the third quarter of 2021. NFT technology can be leveraged to sell (or “wrap”) any kind of property, with a current market focus on the sale of digital art, sports moments, music and similar assets. Expansion of ventures in the “metaverse” increases the relevance of NFTs as a mechanism to purchase digital goods in the “metaverse.”

Guidance on the principles on which to characterize specific NFTs are needed as this asset class expands for retail purchasers. Further, safe harbor rules may be particularly welcome to avoid a

time consuming facts and circumstances analysis for each NFT. Specific sourcing rules for these digital assets are needed, as the nature of such assets as being geographically anonymous makes determining the "location" of title passage (the standard for sourcing certain property sales) difficult to determine. Finally, specific guidance is needed on the information reporting required for NFTs, both as a "digital asset" and whether they also represent digital "goods" (in assessing the potential application of section 6050I reporting for payments of cryptocurrency for non-cash goods and services).