

Digital Assets – Fundamentals, Controls, and Tax Issues

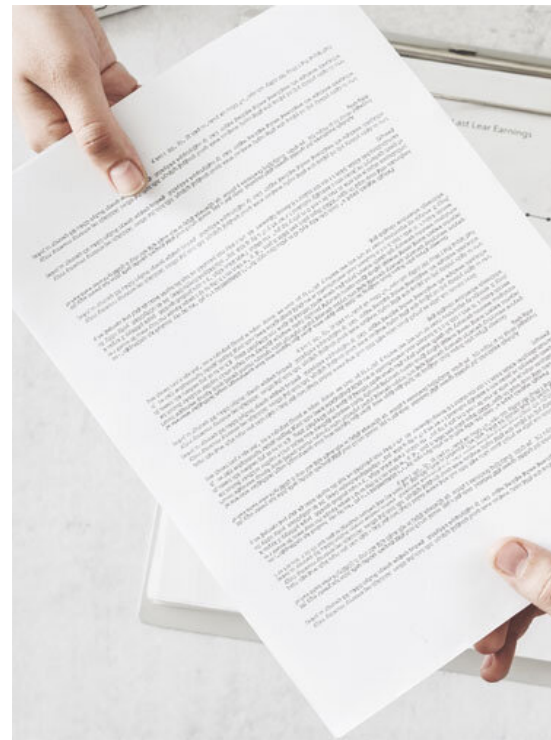
Steve Davenport, and Nishani Vincent

December 13, 2023

Digital Asset

Anything digital that has

- value
- establishes ownership
- is discoverable



Digital, Virtual, and Crypto Currencies

Digital Currency

All virtual and crypto currencies are digital

Not all digital currencies are virtual or cryptocurrencies

E.g. Central Bank Digital Currency (CBDC)

Virtual Currency

Largely unregulated

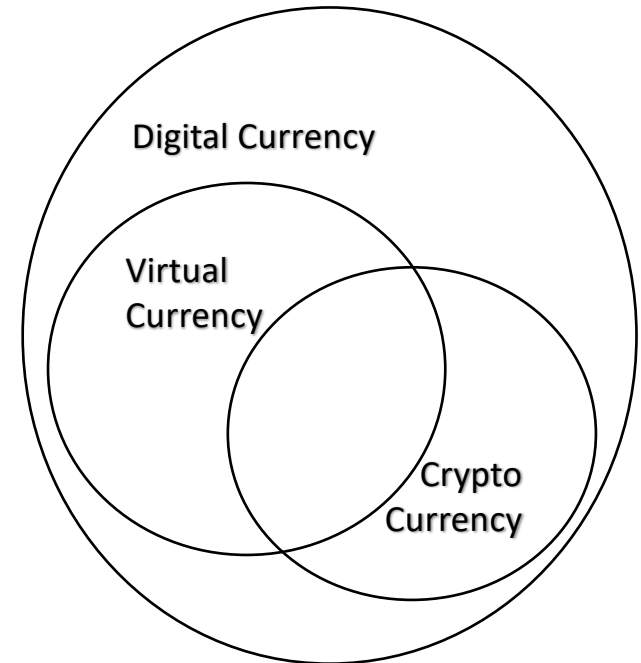
Issued and usually controlled by its developers

Used and accepted electronically among the members of a specific virtual community

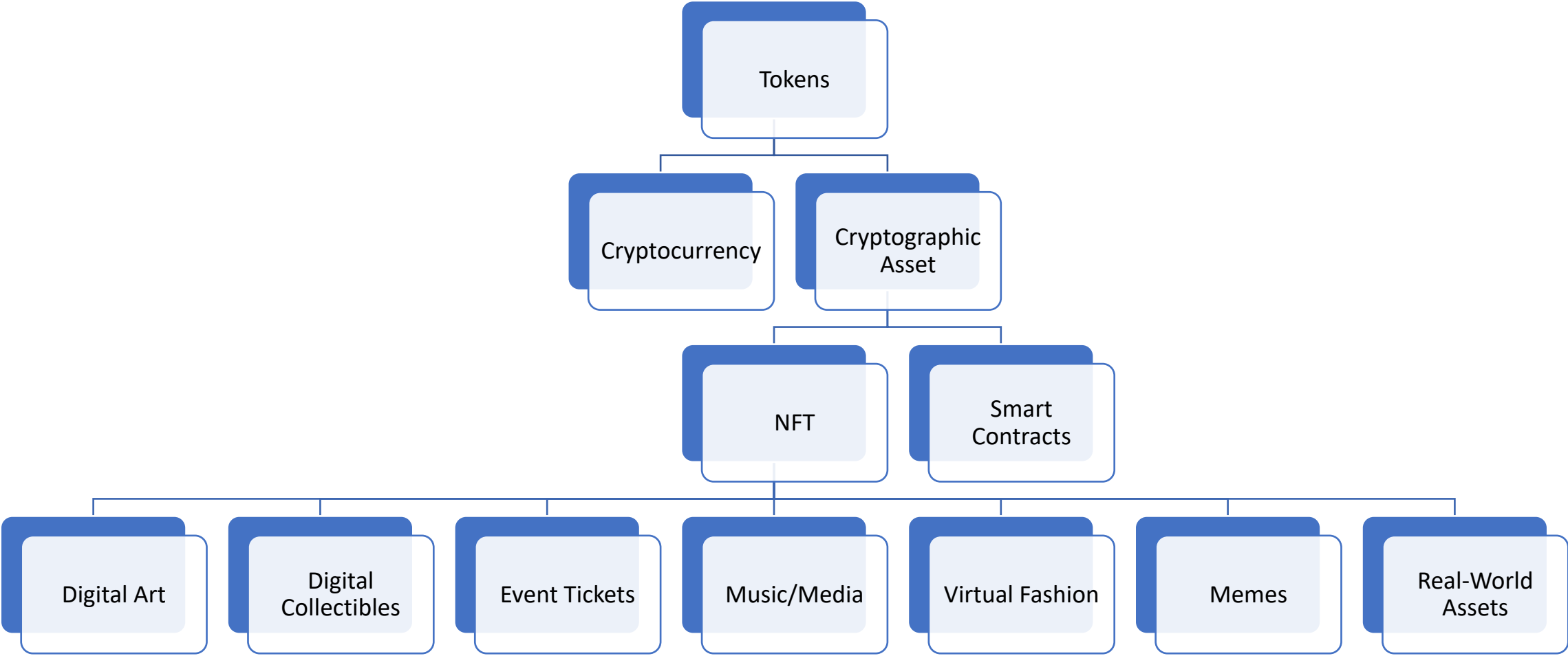
Crypto Currency

Digital/ virtual currency

Secured using cryptography

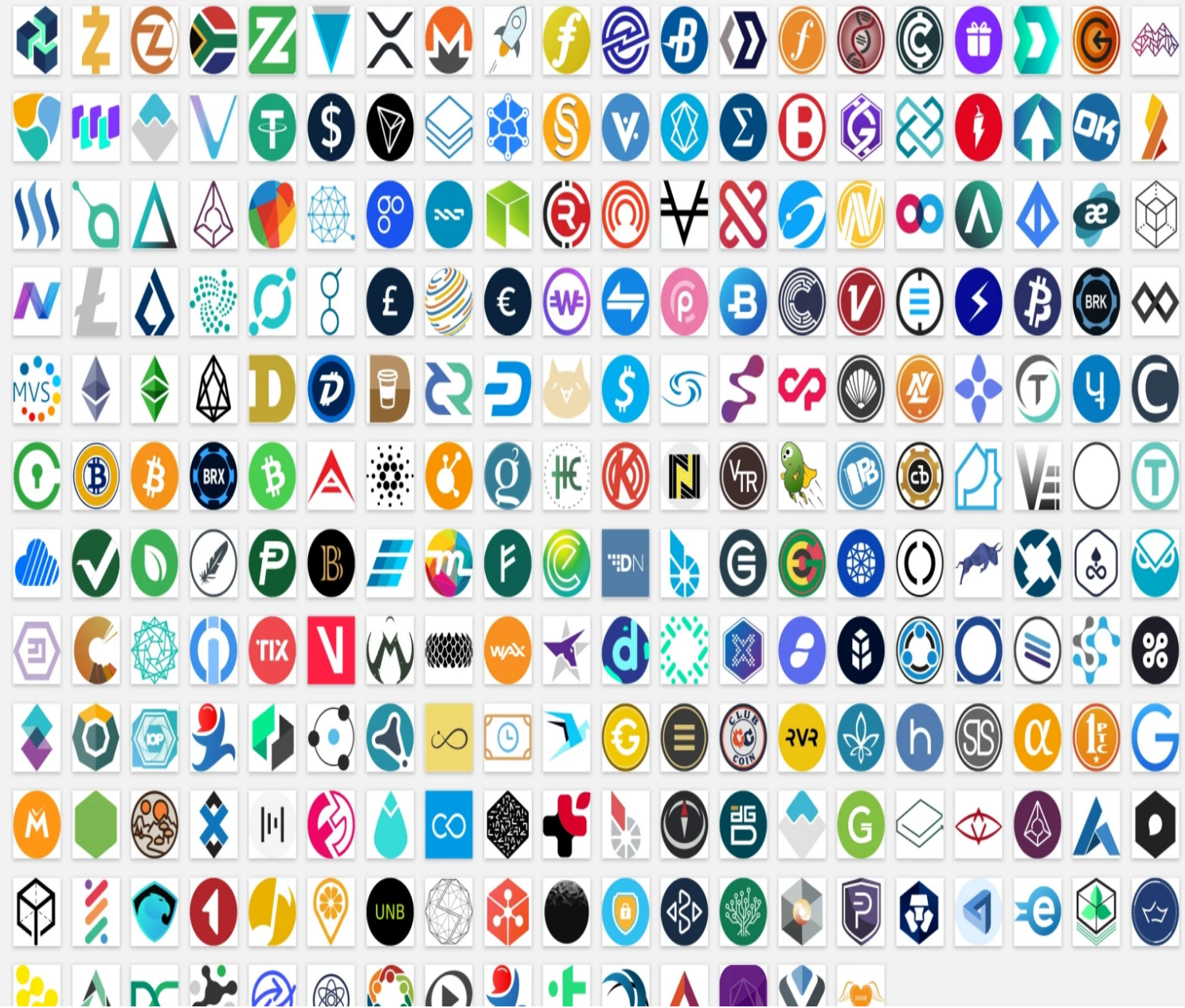


Tokens



Cryptocurrency

- A digital currency
- Designed to work as a medium of exchange
- Using a computer network that is not reliant on any central authority
- Secured using cryptography



Cryptocurrency

Similarities to the Banking Network

- Payment Network
- Ledger
- Validation

The fundamental characteristics of cryptocurrency

- Lack of central authority.
- Anonymity.
- Immutable or Irreversible.
- Scarcity.

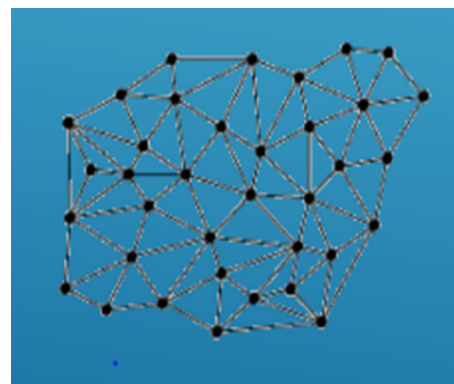


Cryptocurrency Platform: Blockchain

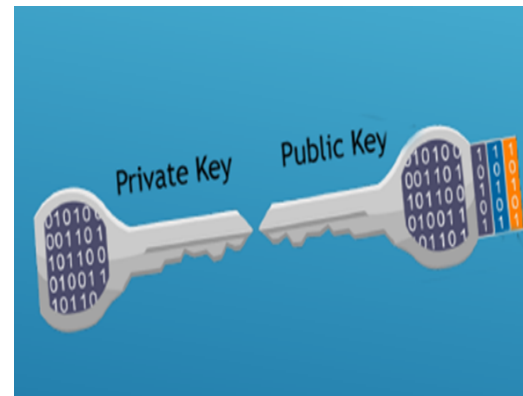
The blockchain is a decentralized distributed ledger that utilizes cryptography and consensus algorithm to ensure the immutability of data.



Decentralized



Distributed Ledger



Cryptography/
Encryption



Consensus Algorithm/
Mining

Bitcoin Cryptocurrency Example

Step 1a: initiate a payment- Wallets
(hot vs cold)



Bitcoin Cryptocurrency Example

Step 1b: initiate a payment-
Private/public key (address)

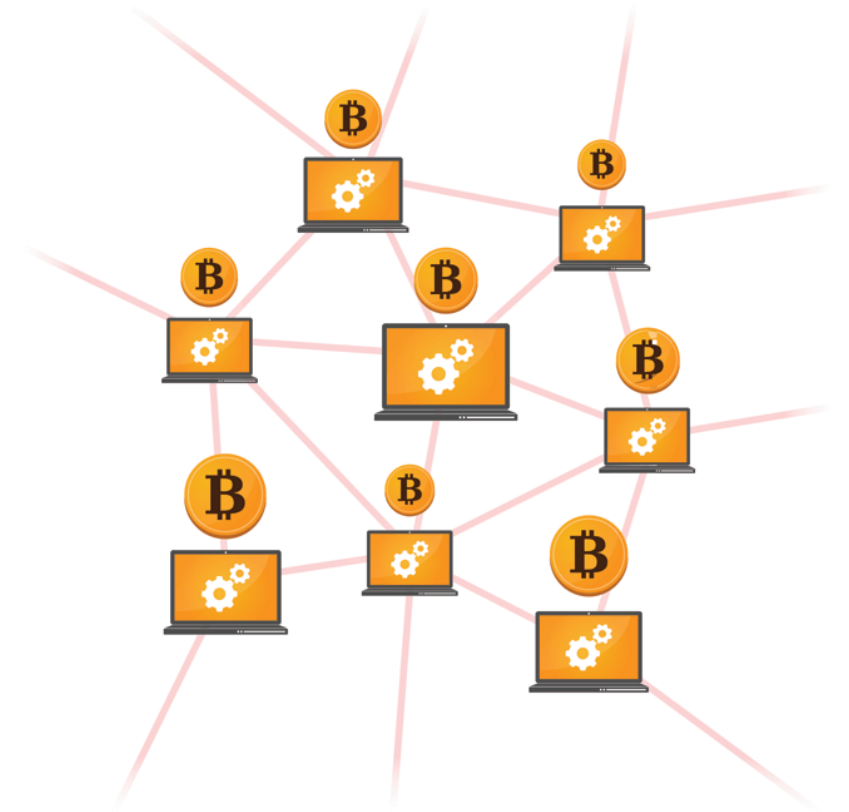
3J98t1WpEZ73CNmQviecrnyiWrnqRhWNLy

A screenshot of a mobile application interface for sending Bitcoin. The screen is titled "Send BTC" and has a close button in the top right corner. Below the title, there are two tabs: "Wallet Address" (selected) and "Email Address". The "Recipient" section contains a text input field with the placeholder "Enter a BTC address". The "Withdraw From" section shows a Bitcoin icon, the text "BTC Wallet", and the balance "0.03557633 BTC ≈ \$398.10". The "Amount" section has two input fields: "0.00 USD" and "0.00 BTC", with a double-headed arrow between them. Below this is a "Note" section with a text area containing the placeholder "Write an optional message". At the bottom, there is a summary section with "Network Fee" and "Total" both set to "0.0000 BTC (\$0.00)". A blue "Continue" button is at the very bottom.

Bitcoin Cryptocurrency Example

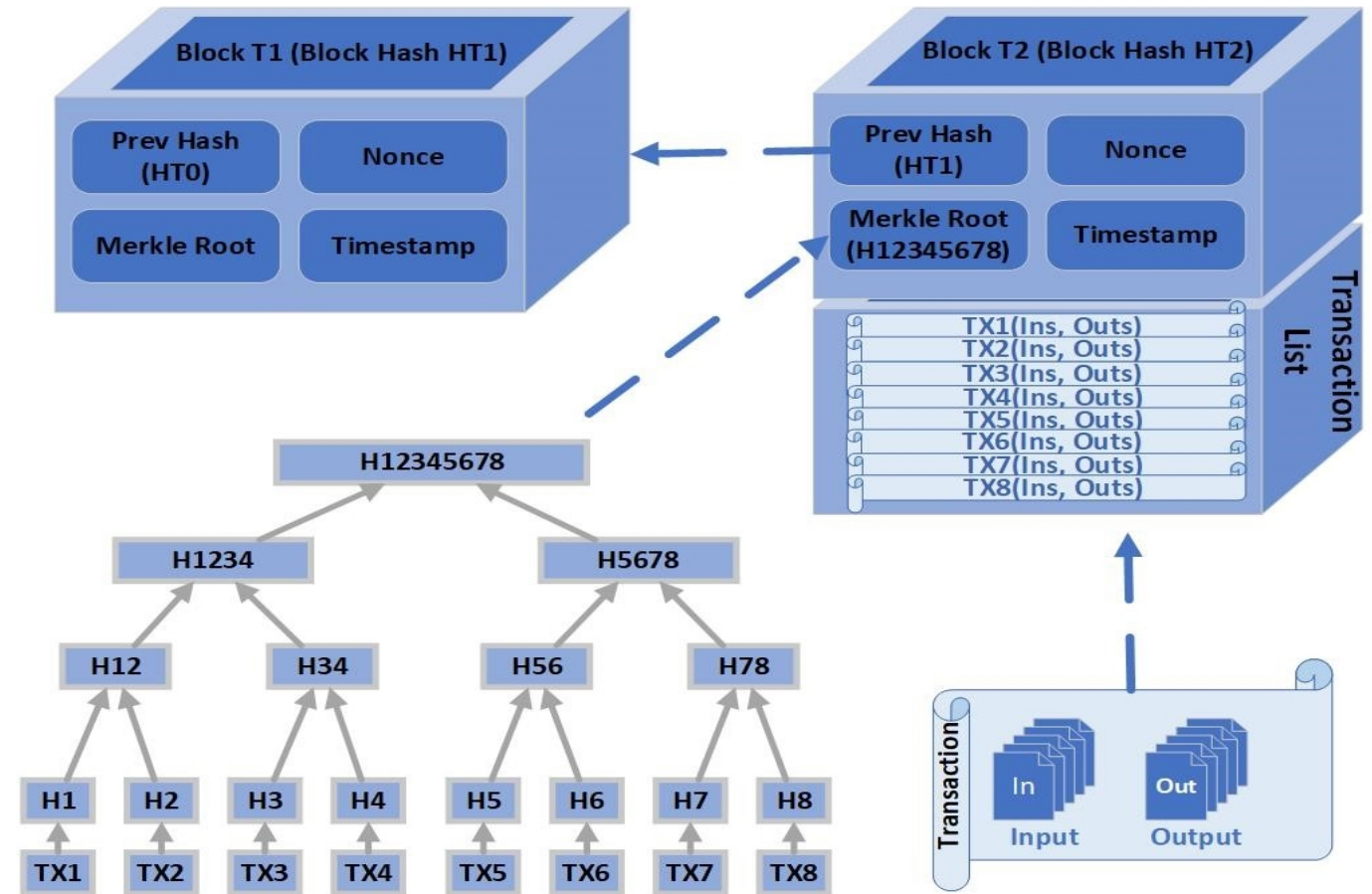
Step 2: submit transaction to the network

- Verify the transaction
- Create a pool of transactions



Bitcoin Cryptocurrency Example

Step 3: Prepare the candidate block



Bitcoin Cryptocurrency Example

Step 4: mining

The goal is to find a value for the nonce that result in a block header hash that is less than the target

HOW TO WIN

for a given block

Target	Disqualified	Disqualified	Viable
00000000	00000000	00000000	00000000
00000000	00000000	00000000	00000000
057FCC70	357FCC70	0D7FCC70	047FCC70
8CF0130D	8CF0130D	8CF0130D	8CF0130D
95E27C58	95E27C58	95E27C58	95E27C58
19203E9F	19203E9F	19203E9F	19203E9F
967AC56E	967AC56E	967AC56E	967AC56E
4DF598EE	4DF598EE	4DF598EE	4DF598EE

Has only 16 zeros. (the target has 17). So all right answers need to have at least 17 zeros

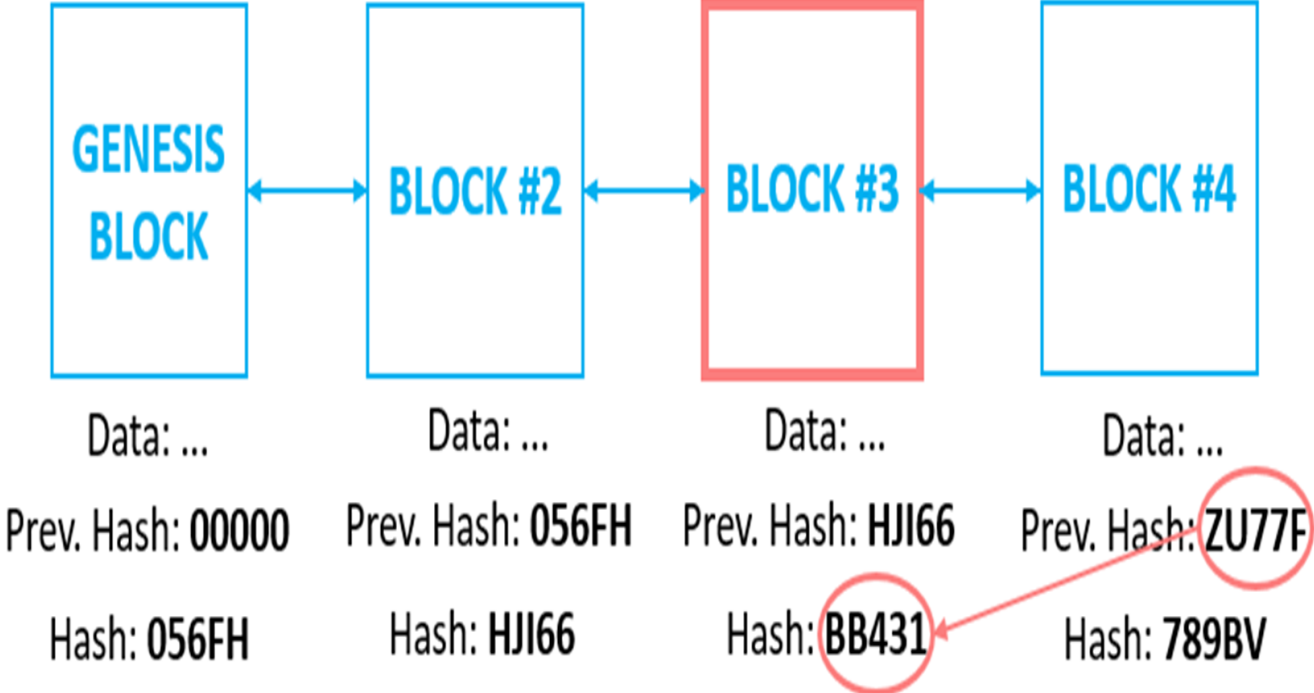
18th digit it's a "d", which in hexadecimal is 13. This is larger than the 18th digit of the target — "5".

Smaller than the target hash. Get there before any other miner and get paid 12.5 BTC

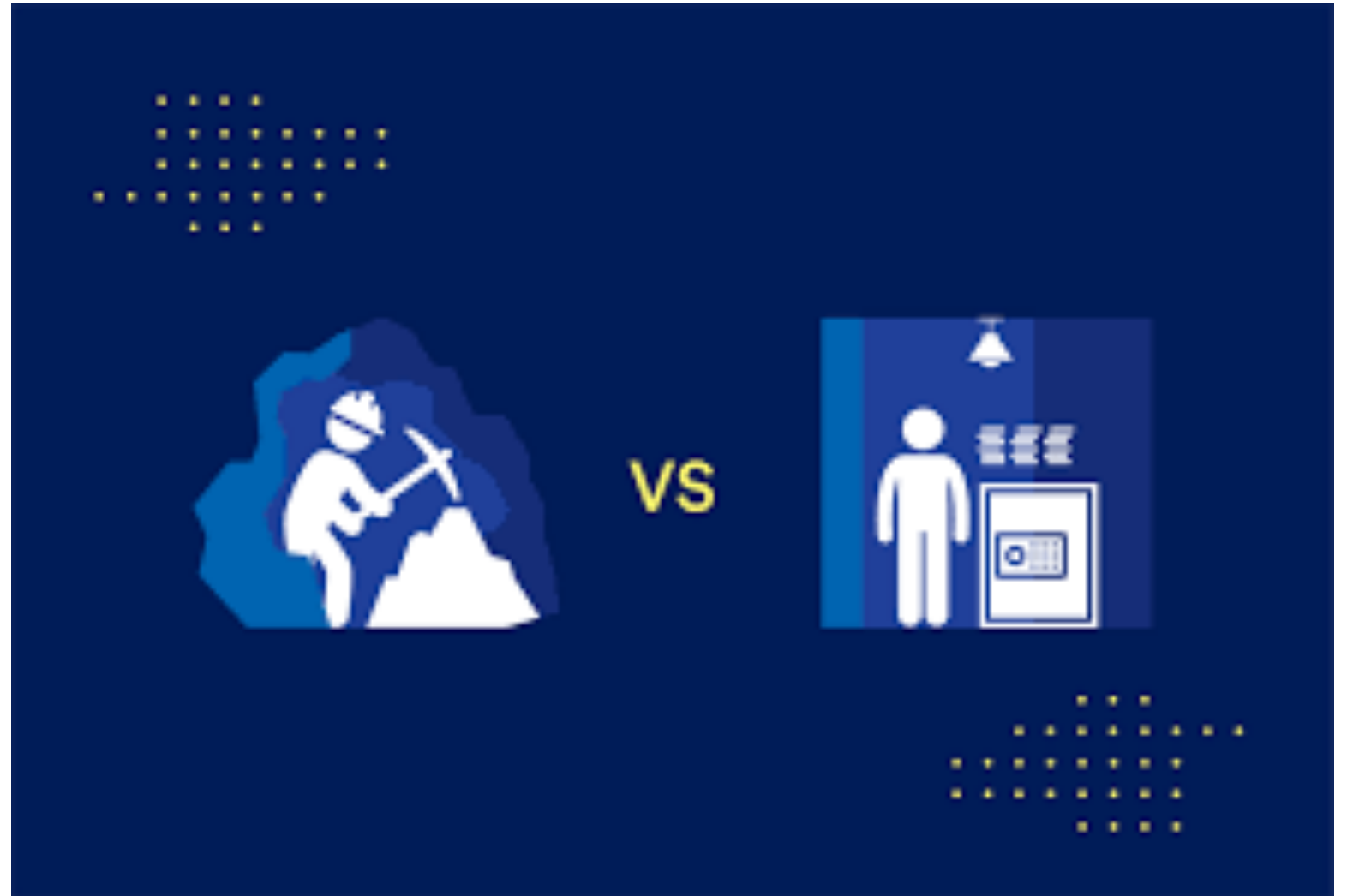
Bitcoin Cryptocurrency Example

Step 5: broadcast the winning block to the network

Step 6: validate the block and accept/add to the blockchain



Mining Vs. Staking



Governance and Management

Choosing a Wallet

- Number of transactions
- Type of cryptocurrencies
- Type of blockchain
- Crypto Exchange
- Geographic locations

Choosing a Crypto Exchange

- Security
- Fees
- Cryptocurrencies offered
- Cryptocurrency storage
- Centralized vs Decentralized

Determining Controls

Wallets

- How many wallets?
- What kind of wallets?
- Who has access?
- How secure are your wallets?

Private Keys

- Who has access?
- How is it stored?
- Succession planning

Risks



Theft/Loss



Resource Usage

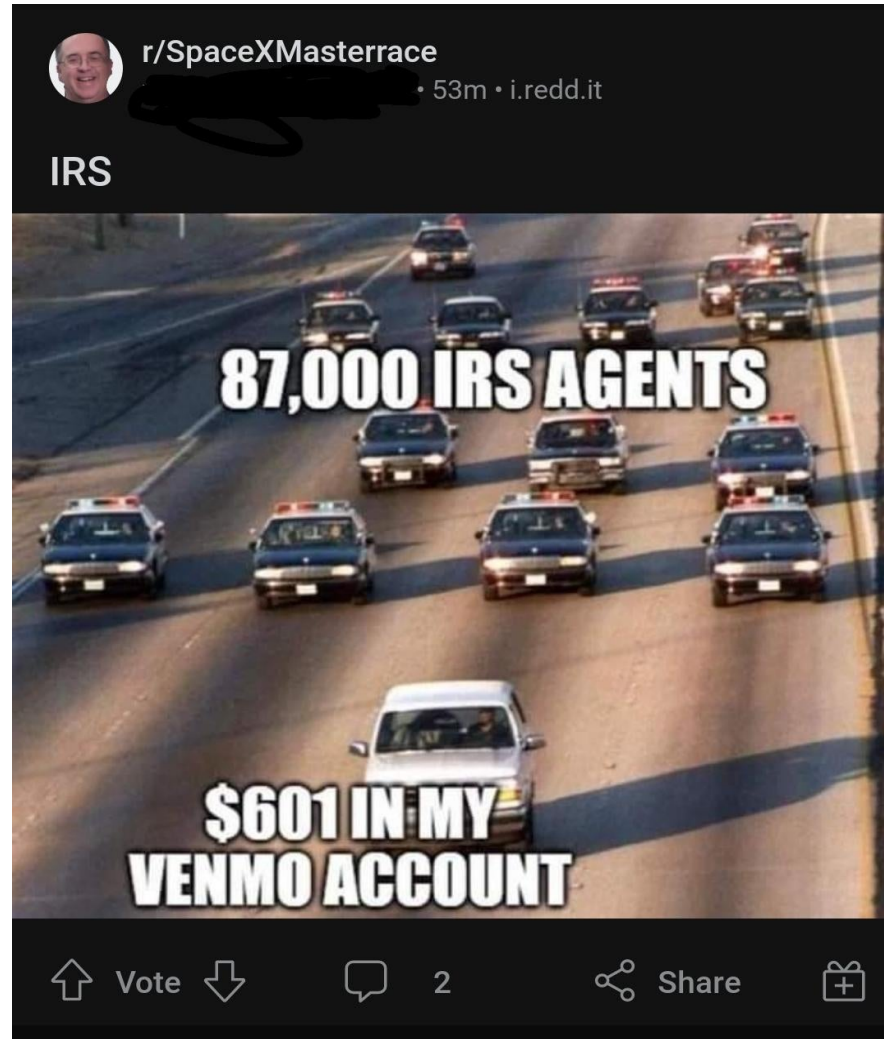


Updates



Accounting
Accuracy

The IRS is coming for your cryptocurrency!



IRS History

- Notice 2014-21
 - Digital Assets treated as property
 - Capital Gain/Loss Treatment
- Revenue Ruling 2019-24
- Notice 2023-27
 - Guidance coming regarding NFTs as collectibles
- Notice 2023-34
 - Clarifies/corrects Notice 2014-21

Where to find Information

- <https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets>
- <https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer>

- Davenport and Usrey (2023a)
 - <https://doi.org/10.2308/JLTR-2022-003>
- Davenport and Usrey (2023b)
 - <https://doi.org/10.2308/JETA-2022-033>

IRC§1221

- Capital Assets are NOT:
 - Inventory
 - Depreciable business property
 - Accounts Receivable
 - Commodities derivatives held by commodities dealer
- Gains/losses treated differently
- Holding period is important

Current Classification Issues

- Recordkeeping
- Capital Losses
- Variety of Types and Uses – Inequitable Treatment



www.coinmarketcap.com

Jarrett v. U.S.

- U.S. District Court for the Middle District of Tennessee
- “Staking” income reported as income on 2019 tax return
- Filed amended return for refund July 2020
- IRS did not respond to refund claim, suit filed May 2021
- IRS awarded refund December 2021
- Jarretts rejected the refund
- Dept. of Justice dismissed the case

Individual Reporting to IRS

Form **1040**

Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return

2020

OMB No. 1545-0074

IRS Use Only—Do not write or staple in this space.

Filing Status Single Married filing jointly Married filing separately (MFS) Head of household (HOH) Qualifying widow(er) (QW)

Check only one box.

If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial		Last name		Your social security number	
If joint return, spouse's first name and middle initial		Last name		Spouse's social security number	
Home address (number and street). If you have a P.O. box, see instructions.				Apt. no.	
City, town, or post office. If you have a foreign address, also complete spaces below.			State	ZIP code	
Foreign country name		Foreign province/state/county		Foreign postal code	
Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.					
<input type="checkbox"/> You <input type="checkbox"/> Spouse					
At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? <input type="checkbox"/> Yes <input type="checkbox"/> No					

Individual Reporting to IRS

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2021

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City, town, or post office. If you have a foreign address, also complete spaces below.			State	ZIP code	
Foreign country name		Foreign province/state/county		Foreign postal code	
<p>Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.</p> <p><input type="checkbox"/> You <input type="checkbox"/> Spouse</p>					
<p>At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? <input type="checkbox"/> Yes <input type="checkbox"/> No</p>					

Individual Reporting to IRS

Form **1040**

Department of the Treasury—Internal Revenue Service

U.S. Individual Income Tax Return

2022

OMB No. 1545-0074

IRS Use Only—Do not write or staple in this space.

Filing Status

- Single
 Married filing jointly
 Married filing separately (MFS)
 Head of household (HOH)
 Qualifying surviving spouse (QSS)

Check only one box.

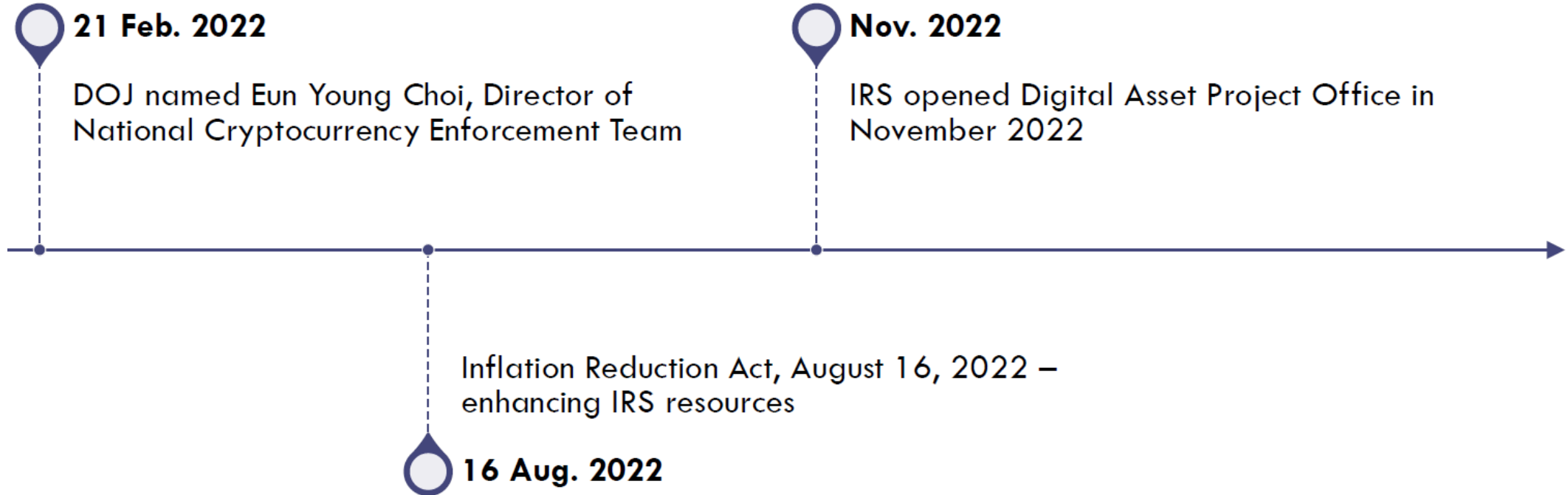
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent:

Your first name and middle initial		Last name		Your social security number	
If joint return, spouse's first name and middle initial		Last name		Spouse's social security number	
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City, town, or post office. If you have a foreign address, also complete spaces below.			State	ZIP code	
Foreign country name		Foreign province/state/county		Foreign postal code	
Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.					
<input type="checkbox"/> You <input type="checkbox"/> Spouse					
Digital Assets		At any time during 2022, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)			
		<input type="checkbox"/> Yes <input type="checkbox"/> No			

Trading Platform Reporting to IRS

- *U.S. v. Coinbase, Inc. (2017)*
 - Broad “John Doe” summons
 - Limited to over 14,000 users with transaction of \$20,000 or more
- *U.S. v. Payward Ventures Inc. (2023)*
 - Parent of Kraken
- Public Law 117-58, sec. 80603 (2021)
 - Reporting requirements for digital assets beginning in 2024

Recent Enforcement Developments



Congressional Involvement

- Joint Committee on Taxation
 - [Report on Digital Assets June 2023](#)
- Senate Finance Committee
 - [Open Comment Letter](#) July 11, 2023

Possible Additional Classifications

- Currency
- Foreign Currency
- Security
- Commodity

Currency

- “a coin or note that circulates as a medium of exchange”
- *SEC v. Trendon T. Shavers and Bitcoin Savings and Trust*
 - *Bitcoin is currency*
- Executive Order on Ensuring Responsible Development of Digital Assets
 - Central Bank Digital Currency (CBDC)?

Foreign Currency

- Nine countries currently have developed CBDC
 - The Bahamas, Antigua and Barbuda, St. Kitts and Nevis, Monserrat, Dominica, Saint Lucia, St. Vincent and the Grenadines, Grenada, and Nigeria
- Two countries have adopted Bitcoin as legal tender
 - El Salvador and Central African Republic

Foreign Currency Treatment

- §988
 - ordinary income and loss for foreign currency transactions
- Notice 2014-21 specifically excludes foreign currency treatment for digital currency

Security

- Securities Act of 1933

- Every offer of securities through interstate commerce must be registered.
- The term “security” includes any note, stock, bond, and investment contracts.

- SEC Jurisdiction

It is “unlawful for any person, directly or indirectly, . . . to offer to sell, offer to buy or purchase[,] or sell” a “security” unless a registration statement is in effect or has been filed with the SEC as to the offer and sale of such security to the public (Section 5 of the Securities Act).

To prove a violation of Section 5, the SEC must show:

(1) that no registration statement was filed or in effect as to the transaction, and (2) that the defendant directly or indirectly offered to sell or sold the securities (3) through interstate commerce.

Security

- *SEC v. Howey (1946) – Investment Contract*
 1. Investment of money
 2. In a common enterprise - Pooling of Assets
 3. Expectation of profit – Income or Return (e.g., Dividends or payments)
 4. Efforts of others
- Howey test used in several SEC cases with cryptocurrency

Commodity

- “an article of trade or commerce that is a tangible good, especially a raw material or agricultural product”
 - IRS defines tautologically in §475
- Commodity Futures Trading Commission (CFTC)
 - *CFTC v. My Big Coin Pay, Inc.*
 - Jurisdiction over Bitcoin futures
 - IRS has relied previously on CFTC classification

Security or Commodity

- *SEC v. Telegram Grp. (2020)*
 - Grams Token - functions as any commodity and “...not likely to be deemed a security...”
 - Efforts to sell Grams to sophisticated investors represent an investment contract under *Howey*.

Security or Commodity

- *SEC v. Ripple Labs (7/13/23)*
 - XRP Token Not a Security
 - Sale of XRP an Investment Contract?
 - Institutional Sales? Yes
 - Programmatic Sales (General Public)? No
 - Other Distributions (Compensation)? No

“By judging that XRP is not a security we’re starting to get clarity on what constitutes a security and what constitutes a commodity —” Chris Martin, head of research at Amberdata, to CNBC (7/13/23)

Security/Commodity Treatment

- §1221 – similar to property
- §1091 Wash Sales
 - Losses disallowed if identical securities acquired 30 before or 30 days after loss transaction
- §475 Mark-to-Market
 - Traders or Dealers of securities or commodities
 - Year-end adjustment is ordinary income/loss

NFTs

- Purchase of Services or Products
- Digital Art or Collectible
 - Notice 2023-27
 - Collectibles -§408(m)

Summary/Conclusion

- IRS and Congress are acting
- Report appropriately on tax return

Questions?

Thank you!

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