The Cryptocurrency Conundrum: The uncertain road toward a coherent oversight structure

ROB GARVER
CONTRIBUTING AUTHOR FOR THE
PROGRESSIVE POLICY INSTITUTE

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INTRODUCTION

The extraordinary growth of the market for cryptocurrencies and other digital assets is one of the most remarkable stories of the past decade. In the United States, an estimated 40 million people have bought and sold digital assets, suggesting that what was once a niche interest is finding its way into the financial mainstream.

In the years after the pseudonymous Satoshi Nakamoto introduced the world to Bitcoin in a 2008 white paper,[1] the use of digital assets[i] grew steadily, reaching a market capitalization of about $14 billion in 2016. Since then, however, the total value of cryptocurrencies and crypto tokens in circulation has skyrocketed, rising to nearly $3 trillion in November 2021, before crashing down to $1.3 trillion in mid-May 2022. On any given day, more than $90 billion in digital assets change hands.

This spring's crypto market collapse is just the latest reminder for investors that crypto assets come with extra risk and volatility, especially in times of economic and political uncertainty. It has also led for calls to establish rules to protect investors and ensure the proper functioning of the markets.

The potential benefits of widespread adoption of cryptocurrencies are many. The ability to make transactions without the assistance of an intermediary, like a bank, could create

i. For purposes of this paper, the terms "digital asset" and "crypto asset" are interchangeable and are meant to encompass both cryptocurrencies and crypto tokens. Technically, all cryptocurrencies are tokens, but not all tokens are cryptocurrencies. The primary difference is that cryptocurrencies, like bitcoin and ether, are the native assets of particular blockchains, like Bitcoin or Ethereum. Tokens are digital assets that are developed on top of an existing blockchain but are not its native currency. For example, there are thousands of different kinds of tokens that have been created to operate within the Ethereum ecosystem.

opportunities for individuals who do not have easy access to traditional financial services. The ability to transfer value quickly and securely across borders could make international trade much more efficient and remittances cheaper and faster. The use of "programmable" money could make complex business arrangements, like revenue sharing, execute in real time with perfect transparency.

However, growing public interest in a new and volatile marketplace is a prospect that has regulators in the U.S. deeply concerned. Fraud in the unregulated crypto marketplace is a significant problem,[2] raising questions about the need for investor protections. Because it is possible to transact in digital assets without the use of an intermediary, like a regulated financial institution, and because those transactions can be made anonymously, such activity has been linked to billions of dollars' worth of illegal activity.[3]

The growing market for stablecoins, tokens with their value pegged to other assets, often a fiat currency, have raised questions about the possibility of systemically destabilizing runs on stablecoin issuers.[4]

As more Americans become interested in investing and transacting in digital assets, there are real questions about whether and how they ought to be handled by existing financial institutions. Should banks be allowed to hold cryptocurrencies on their balance sheets? If so, how would they value the often-volatile assets?[5]

Digital assets also raise important and complicated questions about tax policy. Current U.S. policy holds that every time a token changes hands, it reflects a taxable event, in which the person transferring the token incurs a capital gain or loss, and the person receiving it establishes the basis against which their eventual capital gain or loss will be measured.[6]

The Biden administration, in March 2022, issued a sweeping executive order acknowledging the need for the federal government to adopt a coherent set of policies related to digital assets.[7] While the announcement was welcomed by many in the crypto world,[8] the executive order was light on specifics, effectively pointing out that the federal government has an enormous amount of work ahead of it as it tries to understand and oversee the market for digital assets.

The object of this paper is to identify some of the most significant areas in which regulators and/or the crypto community believe a policy response is required and the work currently being done to address those issues.

Does Crypto Need Its Own Regulator?

There is broad agreement that burgeoning crypto markets need stronger public oversight and rules to protect investors and limit systemic financial risks. That agreement breaks down, however, over the question of who should do the regulating.

Among Washington lawmakers and regulators, not surprisingly, the prevailing assumption is that crypto markets ought to be overseen by the federal government's existing set of regulatory agencies and authorities.

Among the companies, exchanges, digital entrepreneurs and think tanks that make up the larger crypto ecosystem, many believe this approach is a dead end.

In October 2021, Coinbase, the largest U.S. crypto exchange by volume, published a Digital Asset Policy Proposal[9] arguing that, "Forcing the full spectrum of digital assets into

supervisory categories codified before the use of computers risks stifling the development of this transformational technology, thus pushing offshore the innovative center of gravity that currently sits in the United States."

Instead, the company proposed the creation of a new "framework" for regulating digital assets, including the establishment of a new regulatory agency dedicated to digital asset markets.

Arguments in favor of a dedicated regulator include the obvious: A crypto regulatory agency would bring focus to the treatment of assets that are, in important ways, different from traditional investments. On the other hand, it might also avoid the possibility that the growth of cryptocurrencies could be hindered by financial services regulators who have been "captured" by the legacy institutions they oversee — institutions that may not welcome competition.

Another influential voice in the discussion of crypto regulation is the venture capital firm Andreessen Horowitz, which has invested billions of dollars in the crypto industry and has hired a large number of former federal regulators. Last year, the firm released a number of proposals[10] challenging the federal government to reimagine the way it regulates internet-based activity, and blockchain-related activity in particular.

In April, Representative Patrick McHenry of North Carolina, the senior Republican on the House Financial Services Committee, and its likely future chairman if the GOP takes control of the House in 2023, signaled that he is very receptive to the idea of a separate regulator for digital assets.

In an interview with Punchbowl News,[11] Rep. McHenry said that Congress needs to develop a legal definition of a digital asset, and to create a "separate regulatory sphere for digital assets, that is neither the [Securities and Exchange Commission], nor the [Commodity Futures Trading Commission]." Both agencies, he said, "lack the capacity" to regulate digital assets effectively.

Not all lawmakers agree with McHenry. The same week that he made those comments, a bipartisan group of House Members introduced a piece of legislation that would give the lion's share of regulatory authority over the trading of digital assets to the CFTC.[12] Another pending bill, introduced last summer, would divide the authority over digital asset trading between the CFTC and the SEC, depending on the nature of the assets being traded.[13]

In June, a much-anticipated bill introduced by Senators Cynthia M. Lummis, R-Wyo., and Kirsten Gillibrand, D-N.Y., also proposed placing the bulk of regulatory responsibility for cryptocurrencies under the CFTC. Their bill, called the Responsible Financial Innovation Act,[14] is widely seen as the most likely to move forward, though the process is expected to be slow and to involve many changes to the original text.

This paper seeks not to resolve but to inform the intensifying debate over whether existing or new regulatory bodies should oversee crypto markets. Meanwhile, attempts by legacy agencies to extend their purview to crypto markets are illuminating the key questions and challenges that Washington ultimately will need to answer.

BANKING/FINANCIAL SYSTEM SAFETY AND SOUNDNESS

Existing agencies that oversee banks and related financial institutions have begun grappling with the challenge of the growing digital asset market. In some cases, they are assessing their ability to issue rules relevant to digital assets based on existing authorities. In others, they have called on Congress to pass new laws establishing the framework they need to put meaningful regulation in place.

Balance sheet treatment

A large majority of existing holders of bitcoin, the largest and most popular cryptocurrency, would move their holdings into their primary banks if they had the option to do so.[15] An even larger majority of non-crypto holders say that they would at least consider investing in cryptocurrencies if they could do it through their own banks.[16]

Currently, though, banks have little guidance from regulators as to how they would be expected to account for digital assets on their balance sheets. In November 2021, the Federal Reserve Board, the Federal Deposit Insurance Corp. (FDIC), and the Office of the Comptroller of the Currency (OCC) jointly announced what they called a "policy sprint" in an effort to create some clarity for the banks they supervise.

"Throughout 2022, the agencies plan to provide greater clarity on whether certain activities related to crypto-assets conducted by banking organizations are legally permissible, and expectations for safety and soundness, consumer protection, and compliance with existing laws and regulations."[17]

The agencies promise to address various issues related to banks holding crypto assets, including crypto-asset safekeeping and traditional custody services; ancillary custody services; facilitation of customer purchases and sales of crypto-assets; loans collateralized by crypto-assets; issuance and distribution of stablecoins; and activities involving the holding of crypto-assets on balance sheet.

It is currently unclear when the results of the policy sprint will be made public.

Stablecoins

Stablecoins, crypto tokens with values pegged to other assets, like fiat currencies, were approaching a total market capitalization of $200 billion in April 2022, with the two largest, Tether and USD Coin, accounting for more than half of that valuation.

Currently, they are used primarily as a way of facilitating trades in other crypto assets on digital exchanges. An investor who wants to move assets out of Bitcoin without converting them back to fiat currency can instead buy stablecoins, preserving the ability to quickly move funds back into bitcoin or another digital assets. This is particularly useful for crypto investors who want to maintain unfettered 24/7 control over their assets because, unlike banks and brokerages which close overnight and on weekends, blockchains operate at all hours.

At the federal level, the issues surrounding the issuance of stablecoins have been explored at greater depth than many other cryptocurrency policies. In November 2021, the President's Working Group on Financial Markets, in conjunction with the FDIC and the OCC, issued a detailed report on the topic citing various risks associated with stablecoins and calling for legislative action to address some of them.[18]

The report considers the possibility that use of stablecoins might move beyond the

facilitation of digital asset sales and become a broadly accepted form of payment. Should that happen, the report warned that the "failure of stablecoins to maintain a stable value could expose stablecoin users to unexpected losses and lead to stablecoin runs that damage financial stability." Further, it warned of potential disruptions to the payment system that "depending on the extent to which stablecoins are used, undermine functioning in the broader economy."

The report said that sharp growth in the market capitalization of stablecoins could pose systemic risk to the financial system and that issues surrounding their potential use in money laundering and terrorist finance need to be considered.

While the report found that the Securities and Exchange Commission and the Consumer Financial Protection Bureau have some of the legal authority they need to craft regulations for the stablecoin market, it said that there are "key gaps in prudential authority over stablecoins used for payments purposes."

The report recommended that "Congress act promptly to enact legislation to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal prudential framework on a consistent and comprehensive basis."

The working group urged Congress to establish a law restricting the ability to issue stablecoins to "insured depository institutions" — essentially banks. The degree of regulations to which federally insured institutions are subject would, presumably, protect against the possibility that a stablecoin issuer might fail to maintain adequate assets backing up the coins it issues.

The concern about stablecoins failing to maintain their value became very real in May of 2022, when the "algorithmic" stablecoin TerraUSD broke its peg and saw its value plummet. From a market capitalization of more than $41 billion at its peak in April, Terra fell to less than $1 billion in mid-May.

Additionally, the working group called for a law requiring federal oversight of digital wallet providers, which facilitate the sale and purchase of stablecoins, and legislative action creating restrictions on the ability of stablecoin issuers to affiliate with commercial entities. Regulations of digital wallets, according to the report, "should include authority to restrict these service providers from lending customer stablecoins, and to require compliance with appropriate risk-management, liquidity, and capital requirements."

Central Bank Digital Currencies

A number of governments around the world have begun to issue, or are considering issuing, central bank digital currencies (CBDCs).[19]

In the United States, the Federal Reserve has said that it is giving serious consideration to creating a CBDC, but has indicated that the process will be slow and careful, and that it "does not intend to proceed with issuance of a CBDC without clear support from the executive branch and from Congress, ideally in the form of a specific authorizing law."[20]

Among the theoretical benefits of a CBDC, according to the Fed, is that it would "provide a safe foundation for private-sector innovations to meet current and future needs and demands for payment services." It would also reduce the costs and improve the efficiency of cross-border payments and preserve the U.S. dollar's dominance as the world's most widely used currency.

The central bank also believes that a CBDC would promote financial inclusion: "Private-sector electronic transactions accounts facilitate access to digital payments; enable rapid and cost-effective payment of taxes; enable rapid and cost-effective delivery of wages, tax refunds, and other federal payments; provide a secure way for people to save; and promote access to credit."

Among the potential downsides of a CBDC is that, if it were adopted broadly, people might replace their existing bank account balances — which are a liability of a private, albeit highly regulated, business — with CBDC holdings. While this could add an extra degree of security to individuals' assets, and might make some transactions more convenient, if CBDCs become a widely accepted form of payment, it could do real harm to the existing banking system.

However, according to the Fed, "This substitution effect could reduce the aggregate amount of deposits in the banking system, which could in turn increase bank funding expenses, and reduce credit availability or raise credit costs for households and businesses."

Another possible problem is that in times of economic uncertainty, individuals might opt to pull money out of private financial institution accounts in favor of the less risky CBDC. This "could make runs on financial firms more likely or more severe," the Fed warned.

Finally, it is unclear what sort of impact a CBDC might have on the effectiveness of the Fed's implementation of monetary policy. In particular, the Fed is exploring the possible effects that broad adoption of a CBDC might have on the central bank's ability to manage its reserves.

While a CBDC would likely share some properties with other crypto assets, a CBDC would also be different in several important respects. Crucially, as a liability of the Federal Reserve, the bank notes, "a CBDC would be the safest digital asset available to the general public, with no associated credit or liquidity risk."

In January, the central bank issued a discussion document laying out some of the pros and cons of issuing a CBDC and requested public comment.[21] While the Fed paper does not take a firm position on whether and how to implement a CBDC, it assumes that if it were to do so, the digital currency would have four core attributes:

Privacy-protected: According to the Fed's analysis, "Any CBDC would need to strike an appropriate balance … between safeguarding the privacy rights of consumers and affording the transparency necessary to deter criminal activity."

Intermediated: The Fed would not offer individual accounts to the general public. The use and storage of a CBDC would be facilitated by the private sector via accounts and digital wallets.

Transferable: The intermediated system would have to preserve "the ability to transfer value seamlessly between different intermediaries."

Identity-verified: Intermediaries would be subject to the same kind of anti-money laundering rules applied to mainstream financial services providers, which require them to verify the identity of account holders.

In April, Senator Pat Toomey, R-Pa., released a discussion draft of legislation that would create a framework for the issuance of a stablecoin for use in payments.[22]

BANK SECRECY ACT/SANCTIONS COMPLIANCE

As long as cryptocurrencies have existed, law enforcement agencies have recognized their potential for abuse. With strong privacy protections encoded in their DNA, cryptocurrencies like Bitcoin enable individuals to make anonymous peer-to-peer transactions. The possible applications for illegal activity, including payment for illegal goods and services, money laundering, and even terrorism financing were clear from the start.

In practice, though, the vast majority[23] of crypto transactions happen via an intermediary, known variously as a virtual asset service provider (VASP) or a money services business (MSB), depending on which regulatory body is describing them. It is on these entities that the bulk of regulatory focus has been directed.

Crypto exchanges and the 'travel rule'

In the United States, the Financial Crimes Enforcement Network, the Treasury Department agency focused on combating money laundering, terrorist finance and other financial crimes, has long held that the crypto exchanges are subject to the same rules as money transmitters.[24]

This requires companies that facilitate the purchase and sale of digital assets to observe the same know-your-customer (KYC) requirements as other financial institutions, meaning that they need to establish to the regulator's satisfaction that they have positively identified their customers before allowing them access to their services.

Privacy being a core value to many in the crypto industry, there was considerable resistance to these requirements at first, with some exchanges decamping to jurisdictions with looser policies. However, in 2018, the Financial Action Task Force, an intergovernmental body with 39 members, including the world's largest economies, announced that it would recommend to its member countries that crypto exchanges be made subject to what is known as the "travel rule."

An outgrowth of the U.S. Bank Secrecy Act, the travel rule specifies that when a financial institution transfers funds above a certain threshold to an account holder at a different institution, it must collect and retain data about the transaction, including the personal identifiable information of the sender and the recipient.

When FATF announced that it would recommend applying the travel rule to VASPs, the industry accelerated its efforts to comply. However, progress has been slow,[25] and has been hampered by a lack of regulatory guidance from the relevant authorities in numerous FATF member countries.[26]

Sanctions evasion

Even before the Russian invasion of Ukraine in February 2022, and the ensuing regime of international financial sanctions on the Russian economy, the possibility that digital assets might be used to circumvent sanctions has been a concern of U.S. regulators.

In November 2021, the Treasury Department's Office of Foreign Assets Control (OFAC) issued guidance warning start-up virtual currency services that sanctions compliance tools needed to be in place before they began doing business.[27]

Federal agencies, including FinCEN and OFAC, have indicated that they are working to prevent cryptocurrencies from being used as a mechanism for sanctions evasion. However, experts are unsure of how much ability they have

to track all illicit activity and believe that they may have to rely on the assistance of private sector actors to identify it.[28]

When Russia launched its attack on Ukraine, some lawmakers raised concerns about the effectiveness of the federal government's response. In a letter to Treasury Secretary Janet Yellen shortly after the war started, several senators noted multiple instances in which cryptocurrencies had been used to avoid U.S. sanctions in the past and requested information about the department's plans to prevent it happening in the future.[29]

In March, Senator Elizabeth Warren, D-Mass., introduced the Digital Asset Sanctions Compliance Enhancement Act of 2022[30] which would, among other things, require the Biden administration to identify any foreign person operating a cryptocurrency exchange who has facilitated evasion of the sanctions imposed on Russia. It would also give the Treasury Secretary the legal authority to bar U.S.-based cryptocurrency exchanges from doing business with exchanges based in Russia.

INVESTOR AND CONSUMER PROTECTION

For most of the first decade of the crypto ecosystem's development, regulation of how and where cryptocurrencies were bought and sold was virtually non-existent. However, over the past several years regulators, in particular the Securities and Exchange Commission, have begun actively assessing the way that existing regulations regarding the sale of securities should be applied to cryptocurrencies.

The announcement in April that Fidelity Investments plans to include the option to invest in Bitcoin as part of the 401(k) retirement plans that it manages on behalf of many U.S. businesses will only accelerate that process.[31]

Securities or Commodities?

There are several important distinctions that have to be made when considering how to regulate the sale of cryptocurrencies. One of the most fundamental is whether they constitute securities in the first place.

In making that determination, the SEC relies on something called the "Howey test," named after a 1946 Supreme Court decision. The test defines an asset as an "investment contract" if it meets three criteria. It must include 1) an investment of money in 2) a common enterprise that offers 3) the reasonable expectation of profits derived from the efforts of others.[32]

The two largest cryptocurrencies by market capitalization, bitcoin and ether, both fail the Howey test, and are not considered securities contracts. This is because they are produced in a decentralized "mining" process, rather than being issued by a corporation. For that reason, bitcoin, ether, and other cryptocurrencies that are created in a similar fashion are regulated by the Commodity Futures Trading Commission, an agency founded in 1975 to regulate a futures market that was rapidly expanding beyond agricultural commodities and into complex financial instruments.

However, many cryptocurrencies are issued directly by corporations, often in so-called "initial coin offerings, which are intended to raise money for the future activities of the corporation. The SEC has said that it views these coins as securities that are subject to registration. In some cases, companies have pushed back against the designation, arguing that in some ICOs are more equivalent to a "presale" of a good or service that the company intends to offer.

The SEC has had some success challenging companies that have issued cryptocurrencies or related assets without registering them. In 2020, it secured a $5 million settlement from Kik Interactive, over charges that the company had issued one trillion digital tokens, called "kin," without meeting registration requirements.[33] In February 2022, it reached a $100 million settlement with BlockFi, which allowed investors to "lend" digital assets to the company in exchange for interest payments.[34] The SEC claimed that those accounts amounted to investment contracts.

A major case still working its way through the system is SEC v. Ripple Labs, Inc. Ripple is the issuer of the XRP token, one of the top ten cryptocurrencies by market capitalization as of May 2022. The agency claims that the company and its executives have been selling XRP since 2013 in what amounts to an illegal securities offering.[35] Unlike the previous cases, which ended in settlements, SEC v. Ripple is being aggressively contested by the defendant and may result in clarity from federal courts about the securities status of cryptocurrencies.

Crypto exchanges

In addition to regulating individual cryptocurrencies that it regards as securities, the SEC is also working toward rules that will govern the exchanges on which cryptocurrencies trade. In April, SEC Chairman Gary Gensler, said that his agency is engaged in several different projects aimed at bringing regulation of crypto exchanges into line with securities exchanges.[36]

Gensler is a former Goldman Sachs banker, CFTC Commissioner, and Treasury official. He spent several years teaching and doing research on blockchain technology at the MIT Sloan School of Management, and has expressed deep skepticism about the suitability of cryptocurrencies as an asset class for retail investors.

"Congress gave us a broad framework with which to regulate exchanges," Gensler said. "These crypto platforms play roles similar to those of traditional regulated exchanges. Thus, investors should be protected in the same way." Some in the industry have argued that the crypto space is so different from traditional securities markets that trying to shoehorn crypto exchanges into the existing SEC model will not work. A number have called for the creation of a specialized regulator to oversee cryptocurrency trading.

One wrinkle in requiring registration with the SEC is that most major crypto exchanges offer coins that it considers securities as well as others it considers commodities. In the U.S., securities and commodities are traded on separate exchanges, with separate regulators. Gensler said that his staff is working closely with the CFTC to establish how they can jointly oversee such operations.

Another unique feature of crypto exchanges is that, unlike traditional securities exchanges, many take custody of their customers' assets. In general, this means that the exchange is in possession of the private key to a customer's crypto wallet. Gensler has expressed concern that this presents additional risk for investors and has asked SEC staff to determine whether it would make sense to require that custody of crypto assets be relegated to third parties.

In a related issue, in March the SEC issued guidance on how companies that hold crypto assets for their clients ought to account for those assets.[37] The agency observed that, "The obligations associated with these arrangements involve unique risks and uncertainties not

present in arrangements to safeguard assets that are not crypto-assets, including technological, legal, and regulatory risks and uncertainties."

It recommended that companies safeguarding crypto assets for clients carry those assets on their books as liabilities, and disclose them, including "the nature and amount" that they are holding to their investors. It advised reporting the liability at fair value as of the day of the report.

The SEC is also concerned by the fact that some crypto exchanges simultaneously operate as "market makers" in specific coins. They simultaneously offer to buy and sell specific coins, adding liquidity to the market. This means that they are trading on their own behalf at the same time that they are placing orders for clients. Traditional securities exchanges do not act as market makers, and Gensler has asked SEC staff to consider whether it is necessary to legally separate market making in cryptocurrencies from the operation of exchanges. Coinbase, the largest cryptocurrency exchange, has said that its market making decisions are strictly separated from other business decisions that might create a conflict.

Decentralized finance

An area in which regulatory policy is only just beginning to take shape is in the oversight of what is known as "decentralized finance," or DeFi. In general, DeFi refers to applications built on blockchains that are designed to cut the middleman out of financial transactions through the use of "smart contracts."[38]

Smart contracts are self-executing transactions that take effect when a series of predetermined conditions are met. They allow both parties to a transaction to be instantly certain that it has been executed, removing the need for a "trusted intermediary" such as a bank or brokerage house.[39]

In practice, it is possible to structure a series of smart contracts in a way that replicates a number of different kinds of financial transactions, including the sale of securities, lending, insurance, and more.

The difficulty in regulating DeFi is in locating the party responsible for the service being provided. Unlike a cryptocurrency exchange, which operates as a commercial business, a blockchain-based application that simply allows interested parties to enter into agreements to exchange assets needs no physical address or human management.

In January, the SEC signaled one approach it might take in an amendment to rules that have traditionally governed special exchanges for U.S. government securities.[40] The 654-page document contained no direct references to cryptocurrencies, but DeFi experts immediately homed in on the expansion of the definition of "exchange" to include a "communication protocol system."

The SEC does not define the term, but experts in digital assets law pointed out that it could easily be applied to a DeFi platform and the individual or individuals who, as the agency puts it, "make it available."[41]

TAX TREATMENT OF CRYPTO

There is broad acceptance across the cryptocurrency community that the tax laws of the United States apply to crypto transactions, but exactly how they apply is, in many cases, an open question. That's because the Internal Revenue Service, chronically understaffed for the past decade, has been slow to provide clarity on a broad number of questions.

"Tax policy is, by far, the area of U.S. policy that's the furthest behind, as far as having sensible, easy-to-follow rules for people in the space," said Peter Van Valkenburgh, director of research at industry lobbying group Coin Center. "The IRS, when it has issued guidance, has been perennially late. And that guidance has generally been more confusing than helpful."[42]

And when Congress has tried to step in to fill the gap, the results have not been promising. Last year, as Congress rushed to pass the Infrastructure Investment and Jobs Act, lawmakers included a section directing cryptocurrency brokers to report crypto transactions to the IRS.

The intention was to make it easier for the federal government to collect taxes due on crypto transactions, but the legislative language was crafted without input from the crypto community. When the language in the bill became public, the definition of "broker" for purposes of the reporting requirement was so vague that it could have included bitcoin miners and people who provide "staking" to validate transactions, and even programmers who write the code for digital wallets.

After President Biden signed the bill into law, the crypto industry was momentarily panicked, until lawmakers made it clear that they had not intended to require non-brokers to collect and report transaction data.[43]

Months later, in February 2022, the Treasury Department finally put the issue to rest, indicating that the implementing regulations for the law would limit the requirement to businesses that collect information about digital assets trades in the regular course of their business.[44]

Capital gains tax

The term "cryptocurrency" implies that, like the U.S. dollar, the euro, the yen, and other fiat currencies, bitcoins, ether, and other crypto coins can be used as a medium of exchange. While that is technically true, it hasn't been the case in practice. With some limited exceptions, cryptocurrencies are not broadly accepted as a means of payment.

One reason for that is that in the U.S., as in most of the world, digital assets are treated as an asset for tax purposes.[45] That means that a theoretical transaction in which someone pays for a cup of coffee with bitcoin is treated as the disposition of an asset, meaning that it represents a taxable event.

The person using bitcoin to pay for that cup of coffee would be required to report the value of the bitcoin used in the transaction at the time it was acquired, known as their "basis," and the value of the cup of coffee. If the value of the bitcoin has increased since the time it was acquired, the person buying the cup of coffee owes capital gains taxes on the difference.

From a practical point of view, this makes using digital assets for day-to-day transactions far more burdensome than using fiat currency. There is some movement in Congress to address the problem by creating a de minimis exemption that eliminates the reporting requirement for transactions in which the realized gain is less than $200. The bill, called the Virtual Currency Tax Fairness Act,[46] was introduced by Representative Suzan Delbene, D-Wash., and has bipartisan co-sponsors. However, this is the third consecutive Congress in which a version of the legislation has been introduced. In the previous two, it did not receive a vote.

Mining and staking

Some debate remains over the proper way to tax cryptocurrencies when they are created, or "mined." The nature of blockchain technology is such that, to assure the security and continuity of the distributed ledger system, a group of "validators" are required to approve each new block that is added to the chain.

In order to create incentives for validators to perform this work, they are typically "rewarded" with a specific amount of the cryptocurrency for each block that they successfully validate. The process, popularly known as "mining," can take various forms. Bitcoin, for example, uses a "proof of work" model, which requires enormous amounts of computing power to validate each new block. The Ethereum blockchain, while it began with proof of work validation, is in the process of switching to a "proof of stake" model. In a proof of stake model, validators must already hold a significant amount of the currency they are validating. By staking some of their holdings — temporarily agreeing not to trade them — they earn the opportunity to validate blocks and earn more tokens.

Regardless of the process, every time a new block is validated, new cryptocurrency is created and deposited in the wallet of the miner.

Since at least 2014, the IRS has ruled that cryptocurrency earned as part of a mining process counts as gross income for the recipient and is taxable at the fair value of the currency on the day it was received.

However, many in the cryptocurrency community disagree. Some argue that cryptocurrency mining is an act of creation, and that taxing a miner on validation rewards is like taxing a baker when he takes a loaf of bread out of the oven. They argue that mining rewards should only be taxed when they are sold.

That was the thrust of a lawsuit filed by a couple in Tennessee in 2021.[47] Joshua and Jessica Jarrett demanded a refund on taxes they had paid on rewards earned by staking on the Tezos blockchain. The lawsuit, filed in conjunction with the Proof of Stake Alliance, an industry group, was intended to force the IRS to provide legal clarity on the tax status of proof of stake rewards.

The IRS, however, was not prepared to release detailed guidance, and offered to refund the Jarretts' tax payment and settle the case. The Jarretts refused the settlement, and the case is scheduled to go to trial in 2023.[48]

Airdrops and forks

There are certain events that are unique to the cryptocurrency ecosystem which have tax implications that have yet to be fully explained. Among them are "airdrops" and "forks."

An airdrop occurs when the organization promoting a particular kind of token distributes a large number of them for free to individual digital wallets, sometimes without the owners' express knowledge. This typically occurs when a new token is being introduced and is done in an effort to raise awareness and create interest.

A cryptocurrency experiences a "fork" when the rules for adding a new block to the chain are changed.[49] In a "soft fork," the new changes are adopted across all users, and things continue more or less as normal. In a "hard fork," though, the chain splits in two, and people holding the original token find themselves in possession of coins on two separate blockchains.

The IRS created considerable confusion in 2019, when it issued guidance that seemed to confuse the definitions of airdrops and forks.[50] The IRS has since clarified that the recipient of an

airdrop is obligated to report the event as regular income. If the recipient eventually sells the tokens, they will owe capital gains taxes on any increase in value over their fair market price on the day they were received. Similarly, someone who receives new cryptocurrency because of a fork is obligated to report it as income.[51]

However, one complicating factor is that the IRS generally considers the recipient to be in possession of an asset when they are in a position to exercise "dominion and control" over it. Many individuals who own digital assets keep those assets in wallets that are "hosted" by a crypto exchange. When a person receives new tokens because of an airdrop or a fork, they may find that although the new tokens are in their wallet, they don't have effective control over them because the exchange hosting their wallet does not yet support trading in the new token.

Representative Tom Emmer, R-Minn., has introduced H.R.3273: Safe Harbor for Taxpayers with Forked Assets Act of 2021, in an effort to secure still more clarity from the agency.[52]

Taxing NFTs

The surging interest in non-fungible tokens, or NFTs, over the past two years has raised questions about how they ought to be taxed. NFTs are unique digital tokens, often representing a piece of artwork, the rights to a piece of real estate, or another asset.

According to the blockchain data firm Chainalysis, the market for NFTs topped $44 billion in sales in 2021.[53] How these assets should be taxed is an open question. Because each NFT is unique, determining each one's fair market value is difficult in the absence of an actual sale.

Further, it is unclear how NFTs will be treated in the event of a sale. There is little doubt that the seller would owe capital gains taxes on an increase in the NFT's value. However, particularly in the case of NFTs representing a piece of art, it is unclear if the tax applied to the gain would be normal capital gains or the special (higher) rate that the IRS reserves for property classified as "collectibles."

CONCLUSION

The wide variety of legislative approaches to creating regulatory certainty for digital assets speaks to the uncertain policy response to the crypto industry more broadly. There is significant lack of focus, absence of agreement among and between lawmakers and regulators, and no prospect of immediate resolution.

It is not unreasonable to question the degree to which the federal government should spend its limited assets on the creation of a comprehensive legislative and regulatory framework for the world of digital assets. Many crypto tokens, at this point in their development, seem very much like solutions in search of problems.

Indeed, cryptocurrencies writ large have, so far, failed to deliver on the promise inherent in their name. Unlike major fiat currencies, there is not one of them that serves as a widely accepted medium of exchange, and their volatility makes them a dubious store of value and an unreliable unit of account.

However, that must be weighed against the possibility that the crypto ecosystem's explosive growth might continue, bringing more and more people into the universe of digital assets, with real-world effects on the financial security of individuals and families.

Additionally, should some of the more promising use cases of blockchain technology prove viable, the crypto ecosystem has the potential to significantly transform areas as diverse as cross-border payments, management of public assistance programs, and online commerce.

Despite all these challenges and unresolved issues, one thing is clear: The United States has a strong strategic interest in ensuring that the development of this technology is led by U.S. companies with the cooperation and oversight of U.S. lawmakers and regulators.

ABOUT THE AUTHOR

Rob Garver is a freelance writer based in Alexandria, Virginia. He has covered banking and financial services policy for more than 20 years, and currently edits the BankThink section for American Banker.

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PROGRESSIVE POLICY INSTITUTE
1156 15th Street NW
Ste 400
Washington, D.C. 20005

Tel 202.525.3926
Fax 202.525.3941

info@ppionline.org
progressivepolicy.org