Tax Section Comments [5/28/24]

Report and Recommendations of the New York State Bar Association Task Force on Emerging Digital Finance and Currency

June 2024

The Report of the Task Force on Digital Finance & Currency

Executive Summary

The NYSBA Task Force on Emerging Digital Finance and Currency ("Task Force") was formed by Immediate NYSBA Past President Sherry Levin Wallach. The mission statement of the Task Force is: "to study and evaluate the legal issues and questions surrounding the expansion and regulation of the digital finance and digital currency industries in New York State. This review may include the development of best practices for attorneys representing clients on matters in these areas and the proposal of law and policy recommendations to the relevant regulatory bodies in this evolving field."

The Task Force issued its interim report and recommendations, which were approved by the House of Delegates in April 2023.[2] The instant report constitutes the Final Report ("Final Report") and recommendations of the Task Force. The Final Report details the regulatory landscape, possible ways to navigate Web3 businesses through a sandbox approach, **certain** Federal ~~**Income Tax**~~**income tax** considerations regarding digital assets, intellectual property considerations in Web3, navigating the nexus of criminal justice and emerging technologies, as well as ethics and education.

Blockchain's part in this evolution is pivotal, providing the infrastructure for secure, transparent, and intermediary-free transactions. Blockchain technology is at the heart of Web3, including emerging digital finance and currencies, disturbing customary digital commerce and data management practices. By empowering decentralized transactions, blockchain technology reduces the need for central authorities or intermediaries, facilitating a transparent and efficient exchange of digital assets. This technology is not limited to cryptocurrencies but extends to a wide range of applications across finance, healthcare, the arts, and more, fostering innovation and new business models.

Of critical importance, as discussed in the Final Report, the decentralized nature of blockchain presents a unique set of legal challenges and considerations. For those in the legal community, understanding the intricacies of blockchain technology is essential for navigating the legal landscape of digital assets, consumer protection, smart contracts, and the broader implications for intellectual property, data privacy, and commercial transactions. The shift to Web3 has profound implications for digital commerce and data ownership, redefining the legal and commercial frameworks that govern digital interactions. In Web3, the ownership of digital assets and personal data

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https://nysba.org/app/uploads/2022/03/final-no-changes-Task-Force-on-Emerging-Digital-Finance-and-Currency-April-2023-1.pdf

C. *Use Emerging Technologies to Enhance Member Benefits:*

Initiate a request for proposals (RFP) from companies or organizations with expertise in emerging technology to integrate these technologies with those currently in use to increase member benefit and support.

Articles 1, 2 & 3: Recommendations Regulatory Landscape

D. *Enact Clear Federal Legislation on Digital Assets:*

Congress should ~~**prioritize the enactment of**~~**enact** clear, comprehensive federal legislation that specifically addresses the classification, ~~**taxation,**~~ and regulatory oversight of digital assets. This legislation should provide a definitive framework for determining when a digital asset is considered a security, commodity, or a new, distinct asset class. Additionally, the legislation should address the use of digital assets in various sectors, including finance, healthcare, and supply chain management.

E. *Improve and Enhance Appropriate Regulatory Frameworks and Oversight:*

To address the regulatory ambiguity and jurisdictional disputes, proposed legislation should aim to clearly define which agencies are responsible for regulating different aspects of the industry. This includes establishing more objective criteria for when and how crypto assets should move between regulatory regimes. By its nature, this is a global financial service. We need national oversight with state licensing like the rest of the financial and insurance industry.

F. *Establish a Regulatory Sandbox for Digital Assets:*

Regulatory sandboxes are innovative frameworks allowing businesses to test novel products and services in a controlled environment under regulatory supervision. This concept, drawing from the iterative testing approach commonly used in the tech industry, offers valuable insights for both regulators and innovators. It ensures that regulatory frameworks can adapt to technological advances while safeguarding consumer interests and maintaining financial stability.

The United States Federal and State governments should create a regulatory sandbox that allows companies to develop and test innovative digital asset products and services within a safe harbor, under the guidance and supervision of regulators. The sandbox would offer a period of regulatory relief, during which companies can receive input from regulators on the development and alignment of their business models with legal and regulatory requirements.

G. *Foster Innovation and Collaboration:*

Advocate for regulatory bodies to foster innovation in the digital asset space by establishing appropriate regulatory sandboxes or pilot programs. These initiatives should allow for experimentation with digital asset technologies under a relaxed

regulatory framework, subject to oversight and review. Promote collaboration between regulators, academia, and the private sector to research and develop best practices for the use and regulation of digital assets. Additionally, support educational initiatives to enhance the understanding of digital assets and blockchain technology among regulators, law enforcement, and the general public.

H. *Taxation of Digital Assets and Currencies:*

~~**The IRS has not provided taxpayers with sufficient opportunities to engage discussions on the appropriate treatment of block rewards. As a result, there remains significant uncertainty around ancillary questions. We recommend that NYSBA advocate for clear guidelines and rules regarding the taxation of digital assets and currencies.**~~

There is significant uncertainty around the tax treatment of digital assets and currencies. The IRS and Treasury should provide clear guidance to achieve consistency among taxpayers.

Article 4: Intellectual Property Considerations in Web3

I. *International Cooperation and Harmonization:*

Given the global nature of Web3, there is a pressing need for international cooperation and harmonization of trademark laws to tackle the challenges associated with branding digital assets. Developing standardized protocols for the registration, recognition, and enforcement of trademarks across borders could help mitigate some of the jurisdictional challenges posed by Web3.

J. Legal Recognition of Digital Titles:

Laws should recognize digital titles and registrations on a blockchain as legally valid and equivalent to traditional paper titles. This involves ensuring that digital records meet all legal requirements for real property transactions, including evidence of ownership, encumbrances, and liens.

Implementing a hybrid system that maintains traditional title registration mechanisms while integrating blockchain technology could offer a transitional solution. This approach would leverage blockchain's efficiency and security while retaining the legal framework's established protections and recognitions.

Article 5: Navigating the Nexus of Emerging Technologies and Criminal Justice: Challenges and Opportunities in the Age of Digital Currencies and Assets

K. *Continue to explore the implementation of the Use of Blockchain Technology in the Criminal Justice System to Enhance Efficiency and Access to Justice:*

Article 3: U.S. Federal Income Tax Considerations for Digital Assets

While a comprehensive discussion of the U.S. federal income tax treatment of digital assets is outside the scope of this report, this section describes two potential ~~"low-hanging fruits" for improving current U.S. tax policy~~ areas where market participants would benefit from guidance.

SECTION 1: ~~Define taxable~~Taxable exchange

~~We recommend prioritizing~~More detailed guidance on how to determine whether a digital asset transaction is a taxable exchange would be particularly helpful. In the absence of any such guidance, Congress might consider ~~providing~~allowing taxpayers ~~with the option to achieve greater certainty on reporting~~to report their digital asset gains and losses by expanding the applicability of the mark- to-market election under section 475(e)-(f) to "investors" in actively traded virtual currency. Currently, the mark-to-market election applies only to "dealers" and "traders" in virtual currency that is treated as an "actively traded commodity."

Background

The IRS treats virtual currency as property.[157] An exchange of properties generally is taxable only if the properties "differ[] materially either in kind or in extent" within the meaning of Treasury regulations section 1.1001-1(a).[158]

In *Cottage Savings v. The United States*, the Supreme Court determined that properties differ materially either in kind or in extent if they "embody legally distinct entitlements," even if the properties are economically equivalent to each other.[159]

It ~~is not at all clear~~may sometimes be unclear how to apply *Cottage Savings*' "legally distinct entitlements" test to digital assets~~, because digital assets often bear no legal entitlements at all. As a result~~. For example, it ~~often~~ is difficult for taxpayers to ~~determine~~know whether onchain transactions are taxable events.

~~Moreover, in~~In August 2022, Treasury and the IRS issued proposed regulations that, if finalized in their current form, would require "digital asset middlemen" to report "sales" of digital assets on new Form 1099-DA. ~~While a discussion of the proposed regulations is beyond the scope of this report, we are concerned that~~However, so long as there remain significant questions about what types of onchain transactions are taxable

exchanges, market participants ~~are likely to~~may reach conflicting views as to whether they are brokers for that purpose and which transactions (if any) they are required report.

Below we provide examples of several common types of digital asset transactions that ~~might or might not be taxable exchanges~~may raise these issues.

Protocol upgrades

In CCA 202316008, which is widely ~~understood~~believed by market participants to address Ethereum's "Merge," the IRS cited to *Cottage Savings* in concluding that a taxpayer who held a blockchain's native token did not have a taxable exchange by reason of the blockchain's protocol upgrade from proof of work to proof of stake.

Ethereum's Merge, which consisted of ~~who~~two hardforks executed simultaneously in September 2022, was itself the culmination of a broader protocol upgrade that began at least as early as the Beacon Chain hardfork in December 2020.[160] The Beacon Chain hardfork enabled ETH holders to stake their ETH and begin processing "empty" blocks alongside the proof of work Ethereum chain. The Merge required those staking validators to run software accepting transaction data from Ethereum execution clients while original Ethereum clients turned off their mining, block propagation, and consensus logic. As a result of the Merge, Ethereum validators now use a proof of stake consensus mechanism and Ethereum now burns base transaction fees, resulting in an automated dynamic monetary policy.[161]

Protocol developers, application developers, infrastructure providers, and validators worked together to ~~ensure that~~limit the impact on Ethereum users ~~did not feel the effects~~ of the Merge. For example, web3 wallet providers updated their software so that the "ETH" ticker referred to the proof of stake version and "ETHW" referred to the proof of work version, and the Ethereum Foundation, a Swiss nonprofit that owns the Ethereum trademark and is dedicated to supporting the Ethereum ecosystem, advocated for the adoption of the proof of stake chain.

~~In short,~~Although the Merge represented a significant protocol change that required ~~massive~~substantial coordination among diverse market participants to minimize disruption to end- users~~. Nevertheless~~, CCA 202316008 ~~observes (without explanation)~~states that ETH was "unchanged by the protocol change."

The CCA ~~appears~~can be read to stand for the proposition that protocol changes, in and of themselves, do not trigger a taxable exchange of the protocol's native token, regardless

It also included the Berlin hardfork in April 2021 and the London hardfork in September 2021.

Very generally, during times of high network throughput, more ETH is burned than minted, reducing aggregate ETH supply, and during times of low network throughput, more ETH is minted than burned, increasing ~~th~~the aggregate ETH supply.

of how significant those changes are. While that proposition ~~seems reasonable in light of~~**can be justified under** *Cottage Savings*' focus on legal entitlements, **it is unclear how far the CCA extends. Further,** taxpayers generally may not rely on CCAs as precedent ~~and it is unclear to us how far the CCA extends~~.

Because protocol upgrades are a commonplace occurrence in web3, we ~~urge~~**recommend that** the IRS ~~to~~ further study and clarify the circumstances (if any) under which a protocol upgrade should constitute a tax event to tokenholders **and provide additional guidance**.

Noncustodial wrapping

Noncustodial wrapping involves depositing one token (such as ETH) into software in exchange for a 1:1 pegged representation of the same token (such as wETH). Users can wrap or unwrap a token by (1) interacting directly with the wrapping software, (2) exchanging the token for its wrapped counterpart on a decentralized exchange, or (3) engaging a transaction that automatically wraps or unwraps a token within a series of actions.

Noncustodial wrapping is ~~very~~ common in web3; as of November 2022, over 7% of all Ethereum transactions, or about 125 million transactions, involved wETH.[162] While ~~most tax practitioners believe~~**there may be rationales to treat** noncustodial wrapping transactions ~~are~~**as** nontaxable, there are no legal authorities directly on point. As mentioned above, *Cottage Savings* treats two properties as materially different in kind or in extent if they have different legal entitlements~~, and most tokens do not have any legal entitlements~~.

Custodial wrapping

Custodial wrapping involves depositing a token (such as BTC) with a custodian in exchange for the custodian's agreement to mint a new token contractually backed by the custodied token on a different blockchain (such as wBTC on Ethereum). Custodial wrapping requires the assumption of counterparty risk, whereas noncustodial wrapping requires the assumption of software bug and hacking risk. As of March 23, 2024, there were over $10 billion of wBTC in circulation.[163] However, as with noncustodial wrapping, taxpayers do not have any clear guidance **or direct authority to look to** as to whether a custodial wrapping transaction is a taxable event.

See Stephen Tong, Formally Verifying the World's Most Popular Smart Contract (Nov. 18, 2022) ("As of block

Liquidity provision

Liquidity provision is a foundational component of much of decentralized finance: liquidity providers contribute tokens to automated software, which other users can interact with in various ways (such as engaging in token exchanges or token borrowings), often for a fee. In exchange for their contribution, liquidity providers typically receive either: (1) transferrable "bailment tokens" that represent the deposited tokens, plus fees streamed directly to their wallets; (2) transferrable tokens that can be redeemed for a portion of the assets (including accrued fees) held inside of the software; or (3) the ability to claim their portion of fees, and to remove their liquidity from the software, from time to time.

The U.S. tax treatment of liquidity provision is ~~unknown~~**unclear**. Under one approach, a liquidity provider ~~is~~**could be** treated as engaging directly in the activities of the applicable smart contract. If that approach were adopted, liquidity provision presumably would not be a taxable disposition. Under an alternative approach, the smart contract is deemed to ~~be~~**behave** a tax "~~person"~~**personality" separate from the liquidity provider** that is not looked through.[164] If that approach were adopted, liquidity provision presumably would be a taxable disposition. It is also possible that ~~some~~**different approaches are appropriate or applicable to different** liquidity provision arrangements ~~are looked through and others are not~~.[165]

Token borrowing

In a decentralized finance borrowing protocol, users who contribute tokens to software can "borrow" other tokens from the software up to a percentage of the value of the tokens they contributed, and can reacquire tokens identical to the ones they contributed by replacing the borrowed tokens and paying a time-based usage fee.

The U.S. tax treatment of on-chain token borrowing is ~~unknown~~**unclear**. Under one theory, token borrowing is an exchange of one token for another, and therefore is a taxable exchange. Under an alternative theory, token borrowing is a deferred exchange of property for identical property and therefore is nontaxable under ~~the same~~**similar** principles **to those** that led to the enactment of section 1058 **of the Internal Revenue Code**. It also is possible that some types of token borrowings are taxable exchanges, while others are not. Again, in the absence of clear guidance, ~~it is highly likely that~~ taxpayers and their advisors ~~will~~**may** reach conflicting views.

See, e.g., Jason Schwartz, Squaring the Circle: Smart Contracts and DAOs as Tax Entities, https://www.friedfrank.com/uploads/siteFiles/Publications/Decentralized%20Autonomous%20Organizations%20_%20

SECTION 2: ~~Provide more comprehensive guidance on the taxation~~Taxation of consensus layer staking

Under current IRS guidance, block ~~rewards~~ rewards are taxed at their fair market value when a miner or staker has dominion and control over them.[166]

~~A discussion of whether the IRS's position on block rewards represents an appropriate interpretation of the law is outside of the scope of this report. Here we instead express concern that the IRS has not given taxpayers sufficient opportunity to engage with it on determining the proper treatment of block rewards and, as a result, there remains significant uncertainty around ancillary questions.~~

However, there remains significant uncertainty around ancillary questions.

Background on consensus mechanisms

A blockchain is a peer-to-peer network composed of multiple computers (nodes) running open-source software.[167] Although each node acts independently in its own economic interest, the software's incentives are designed so that an information ledger emerges from the nodes' aggregate actions. The incentives are collectively referred to as a "consensus mechanism."

Although each blockchain has its own design, there are broadly two kinds of consensus mechanisms: proof of work and proof of stake.

In a proof of work network, nodes—known as miners in this context—compete to solve a computational puzzle. The first miner to solve the puzzle gets to propose the next block of data for addition to the ledger. If the proposed data block does not contain any transactions that break the network's rules, like "double-spend" transactions or other falsified information, the other nodes validate the "winning" miner's block. In that event, the winning miner receives "block rewards." On the Bitcoin network, block rewards consist of: (1) newly minted BTC and (2) transaction fees. Newly minted BTC currently represents the majority of mining rewards. Transaction fees are fees users are required to pay to include their transactions in a block. If a miner's block is not approved, the miner will not receive any block rewards and, consequently, will be in a net economic loss position after having incurred real-world resources to solve the computational puzzle.

In a proof of stake network, nodes—known as stakers in this context—lock up, or "stake," a material amount of the blockchain's native token in the software they run. The software selects a staker at random to propose a new block of data for inclusion on the ledger. As with proof of work, the other nodes approve the winning staker's block if it

does not contain falsified information, and the winning staker receives block rewards. On the Ethereum network, block rewards consist of: (1) newly minted ETH and (2) "priority gas fees." Newly minted ETH represents the majority of staking rewards. Priority gas fees are fees some users pay in excess of a mandatory "base fee" for faster inclusion in a block. (Unlike Bitcoin, Ethereum's software protocol destroys, or "burns," base fees, thereby offsetting the inflationary effects of newly minted ETH.) If a staker's block is not approved (e.g., because the staker submitted falsified data), all or a portion of the staker's ante is devalued, or "burned."

IRS guidance

The IRS concluded in Notice 2014-21 that "when a taxpayer successfully 'mines' virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income." Similarly, in Revenue Ruling 2023-14, the IRS ~~held~~**concluded** that "[i]f a cash-method taxpayer stakes cryptocurrency native to a proof-of-stake blockchain and receives additional units of cryptocurrency as rewards when validation occurs, the fair market value of the validation rewards received is included in the taxpayer's gross income in the taxable year in which the taxpayer gains dominion and control over the validation rewards."

~~***Problems with IRS guidance***~~

While Notice 2014-21 and Revenue Ruling 2023-14 ~~**reflect the IRS's views, they are not binding on taxpayers. There are two overarching problems with the IRS's approach of describing the treatment of block rewards through nonbinding guidance.**~~**provide important guidance, there remain significant uncertainties and such uncertainties could cause potentially inconsistent treatment among taxpayers.**

First, the guidance does not provide ~~**sufficient**~~**detailed** analysis for ~~**tax practitioners to assess the IRS' position on its legal merits or to reach conclusions on ancillary matters**~~**the conclusion**. As a result, there remains significant confusion ~~**by taxpayers and practitioners**~~**in the digital marketplace** about whether**, for example**: (1) non-U.S. persons are subject to U.S. income or withholding tax when they earn block rewards through a U.S. delegate;[168] and (2) block rewards are taxed as "unrelated business taxable income" to U.S. tax-exempt organizations.[169] ~~**A regulatory project involving notice and comment would have given taxpayers an opportunity to ask these questions and the IRS an opportunity to respond.**~~

Second, ~~**making tax policy through nonbinding administrative guidance rewards taxpayers with sufficient resources to take an alternative position**~~**many market participants are small taxpayers who may lack the resources (or for other**

reasons may not devote significant resources) to engage tax professionals to advise or litigate such issues. Conversely, taxpayers who can and do devote greater resources will be better able to take alternative (more taxpayer favorable) positions, including, potentially, those contrary to IRS guidance. In *Jarrett v. United*

Very generally, non-U.S. persons are subject to U.S. federal income tax on income effectively connected with the conduct of a trade or business within the United States, and are subject to 30% U.S. federal withholding tax (which may be reduced by an applicable income tax treaty) on U.S.-source fixed, determinable, annual, or periodical income that is not effectively connected with the conduct of a trade or business within the United States. Very generally, U.S. tax-exempt organizations are subject to U.S. federal income tax on unrelated business taxable income.

States,[170] **for example,** a home staker sued the IRS for a refund of the tax he paid on his newly minted block rewards, arguing that the rewards were self-created property instead of property received for services. The IRS contested Jarrett's refund suit, then granted his refund and successfully sued to dismiss the case on mootness grounds~~.~~ ~~**The taxpayer's experience in *Jarrett* illustrates that there are currently two tax regimes for consensus- layer stacking: one for taxpayers who can afford to sue the IRS for a refund each year, and one for taxpayers who cannot.**~~ **(with the result that no precedential decision was reached). Consistent treatment of similarly situated taxpayers is an important objective of the tax rules.**

- Currently, the USPTO and USCO have concluded that there is no need for changes to the trademark and copyright laws. However, this issue needs to continue to be studied. The unique nature of digital assets on blockchain platforms necessitates a rethinking of how trademark law is applied. For instance, the use of a specific digital asset (e.g., a unique piece of digital art or a character in a virtual world) as a brand identifier may require adaptations in trademark law to address issues of distinctiveness, use in commerce, and potential infringement in a decentralized context.

B. *Dispute Resolution and Enforcement:*

Developing new legal frameworks and dispute resolution mechanisms that can accommodate the decentralized nature of blockchain transactions is crucial. This might include specialized courts or arbitration panels familiar with blockchain technology and real property law.

C. *Use Emerging Technologies to Enhance Member Benefits:*

Initiate a request for proposals (RFP) from companies or organizations with expertise in emerging technology to integrate these technologies with those currently in use to increase member benefit and support.

ARTICLES 1, 2 & 3: Recommendations Regulatory Landscape

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Regulatory bodies should enhance its regulatory oversight of digital assets by:

- Developing a specialized division within the SEC dedicated to digital assets and blockchain technology. This division would be responsible for providing guidance, overseeing compliance, and enforcing regulations specific to digital assets.
- Collaborating with other regulatory agencies, such as the Commodity Futures Trading Commission (CFTC) and the Financial Crimes Enforcement Network (FinCEN), to ensure a coordinated and comprehensive regulatory approach.
- Review the applicability of the Howey Test and support statutory revisions to provide a clear framework.
- Creating a Clear Registration Scheme which would allow for Establishing counter parties, intermediaries, and exchanges.

F. *Establish a Regulatory Sandbox for Digital Assets:*

Regulatory sandboxes are innovative frameworks allowing businesses to test novel products and services in a controlled environment under regulatory supervision. This concept, drawing from the iterative testing approach commonly found in the tech industry, offers valuable insights for both regulators and innovators. It ensures that regulatory frameworks can adapt to technological advances while safeguarding consumer interests and maintaining financial stability.

The United States Federal and State Governments should create a regulatory sandbox that allows companies to develop and test innovative digital asset products and services within a safe harbor, under the guidance and supervision of regulators. The sandbox would offer a period of regulatory relief, during which companies can receive input from regulators on the development and alignment of their business models with legal and regulatory requirements.

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Advocate for regulatory bodies to foster innovation in the digital asset space by:

- Establishing appropriate regulatory sandboxes or pilot programs that allow for experimentation with digital asset technologies under a relaxed regulatory framework, subject to oversight and review.
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~~advocate for clear guidelines and rules regarding the taxation of digital assets and currencies.~~

Article 4: Intellectual Property Considerations in Web3

I. *International Cooperation and Harmonization:*

Given the global nature of Web3, there is a growing need for international cooperation and harmonization of trademark laws to tackle the challenges associated with branding digital assets. Developing standardized protocols for the registration, recognition, and enforcement of trademarks across borders could help mitigate some of the jurisdictional challenges posed by Web3.

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Laws should recognize digital titles and registrations on a blockchain as legally valid and equivalent to traditional paper titles. This involves ensuring that digital records meet all legal requirements for real property transactions, including evidence of ownership, encumbrances, and liens.

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Article 5: Navigating the Nexus of Emerging Technologies and Criminal Justice: Challenges and Opportunities in the Age of Digital Currencies and Assets

K. *Continue to explore the implementation of the Use of Blockchain Technology in the Criminal Justice System to Enhance Efficiency and Access to Justice:*

Blockchain can be used to provide more secure access and more efficient storage and transfer of data such as for record keeping, maintaining police disciplinary data systems, service of process and to create uniform statewide pre-trial data collection. This will increase the integrity of the system and decrease wrongful convictions and unnecessary or prolonged incarceration.

L. *Consideration Should be Given to the Use of Digital Currency in Certain Aspects of the Criminal Justice System:*

Digital currencies are being used worldwide to bank the unbankable. Further, by their very nature, they provide a secure manner for the transfer of funds while