Blockchain Law

Laying down the law for digital assets

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Federal legislators, regulators and enforcers have been making enforcement pronouncements and new proposals to try to keep up with the social, economic, political and legal issues posed by the issuance, use and trading of digital assets built on blockchain technologies. In this edition of his Blockchain Law column, Robert A. Schwinger describes some of the recent developments.

When it comes to digital assets built on blockchain technologies, Washington has been busy in recent months. Federal legislators, regulators and enforcers have been making enforcement pronouncements and new proposals to try to keep up with the social, economic, political and legal issues posed by the issuance, use and trading of these new kinds of assets. Here's some of what they've been up to:

Legislative Responses to Facebook's 'Libra' Project

Facebook's "Libra" project garnered much attention in recent months both in the press and in Congress. Libra is a proposed "stablecoin," meaning that it is a cryptocurrency that seeks to minimize price volatility, in contrast to highly volatile cryptocurrencies like Bitcoin. Certain financial institutions have themselves announced plans to issue their own stablecoins with a stable value tied to a national currency like the US dollar. But Libra, as discussed in our September 2019 "Blockchain Law" column, rather than being "pegged" to a single asset like some stablecoins, is intended to be backed by a basket of leading world currencies in assets such as cash bank deposits and highly liquid, short-term government securities, with the stated goal of minimizing the exposure its value might face from fluctuations in a single region.

Facebook's Libra project has raised concerns about threats that could be posed by allowing a technology platform with a broad international reach to control a blockchain-based cryptocurrency that might be used for all commerce conducted through that platform. These include threats to competing e-commerce platforms and markets; threats to the businesses who would need to sell their goods and services on the platform and/or who sell in competition with others who sell on the platform; and ultimately potentially threats to the ability of nations to control their own banking and monetary systems, and in particular world-leading national currencies like the US dollar. Perhaps spooked by the prospect that Facebook's proposed "Libra" currency might soon lead to such feared outcomes, several bills have been proposed in the House of Representatives to address the use of cryptocurrencies in these kinds of ventures.

One proposed bill, the "Keep Big Tech Out of Finance Act," H.R. 4813 (Oct. 23, 2019) (C. García, D-Ill.), seeks to bar altogether involvement in cryptocurrencies and other areas of the financial system by what it calls "large platform utilities." The bill defines a "large platform utility" as a "technology company" that has annual global revenue of $25 billion more "that is predominately engaged in the business of offering to the public an online marketplace, an exchange, or a platform for connecting third parties." Companies like Facebook obviously come to mind. The bill would impose two principal restrictions on such large platform utilities, each of which restrictions would hamper projects like Facebook's Libra.

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First, large platform utilities would be prohibited by the bill from being or becoming a US "financial institution" (broadly defined to encompass banks, funds, exchanges, trading systems, various players in the securities, commodities or investment advising areas, and money services businesses, among others) or becoming affiliated with one. If such large platform utilities already are or are affiliated with a financial institution, they will have a one-year period to wind down those activities or affiliations.

Second, the bill provides that a large platform utility may not "establish, maintain, or operate a digital asset that is intended to be widely used as medium of exchange, unit of account, store of value, or any other similar function" as defined by the Federal Reserve. In this regard, the bill defines a "digital asset" as "an asset that is issued and transferred using distributed ledger or blockchain technology, including, so-called 'virtual currencies,' 'coins,' and 'tokens.'" Large platform utilities currently engaged in these activities would likewise have a one-year period to wind down.

Another bill that now is just in the discussion draft stage but which has not yet been formally introduced is the "**Stablecoins Are Securities Act of 2019**" (by Rep. Sylvia Garcia, D-TX). This bill would define a "managed stablecoin" as being a digital asset (which term this bill defines as "any asset, contract, agreement or transaction, including a representation of an economic, proprietary, or access right, that is stored in a computer-readable form and has or will have a transaction history that is recorded in a distributed ledger, digital ledger or other digital data structure") whose market value "is determined, in whole or in significant part, directly or indirectly, by reference to the value of a pool or basket of assets, including digital assets, [that are] held, designated, or managed," or that can be exchanged for fiat currencies or other digital assets based on the value of such a pool or basket of assets.

This bill would add "managed stablecoins" to the definitions of a security under each of the principal federal securities laws. It would also give the SEC the power to issue rules and regulations "to further define the terms 'managed stablecoin' and 'digital asset'" used in the bill.

Such provisions might have the effect of making it impractical for projects like Facebook's Libra cryptocurrency to proceed. As one commentator explained:

> the worst case outcome for … cryptocurrencies established on blockchains would be to receive the treatment as a security. This is the death knell for most companies as needing broker-dealers to facilitate transactions on digital tokens that are not truly "equities" means business cannot exist or scale in any meaningful way.

Jason Brett, "'**Stablecoins Are the New Bitcoin' In Congress,**" Forbes.com (Oct. 26, 2019). However, a stablecoin that is backed not by a managed basket of assets but rather by just a single fiat currency controlled by a government might possibly avoid being deemed a "security" under the definitions in this bill. Id.

A third legislative proposal, also from October 2019, is a currently untitled **discussion draft bill** from Rep. Michael San Nicolas (D-Guam). This bill would limit the ability of issuers of "managed stablecoins" to access the US capital markets, by directing the SEC to issue a rule barring national securities exchanges from listing an issuer's securities (thus prohibiting that issuer from trading on the exchange) if the issuer or its officers or directors (a) "received compensation in the form of a managed stablecoin"; (b) "bought or sold a managed stablecoin"; or (c) were "otherwise affiliated with a person who bought or sold a managed stablecoin after the date of the of the registration of the [issuer's] security."

These provisions would obviously dissuade most if not all issuers from investing in or becoming involved in ventures like Facebook's Libra. This bill relies on the same "managed stablecoin" definition as in the proposed Stablecoins Are Securities Act of 2019, thus again apparently seeking not to interfere with the stablecoins that are not "managed" but merely linked to a governmentally-issued currency.

AML/CFT Obligations as to Digital Assets

Concerns about not allowing cryptocurrency development to undermine governmental controls over the monetary system have also led to more activity from regulators and enforcers. On Oct. 11, 2019, the leaders of the US Commodity Futures Trading Commission (CFTC), the Financial Crimes Enforcement Network (FinCEN), and the US Securities and Exchange Commission (SEC) issued a **joint statement** reminding persons who are engaged in activities involving digital assets of their obligations under the Bank Secrecy Act (BSA), 31 U.S.C. §§5311-5314; 5316-5332 and 12 U.S.C. §§1829b, 1951-1959, to have effective anti-money laundering programs and programs to counter the financing of terrorism (AML/CFT), including recordkeeping and reporting requirements such as Suspicious Activity Reports (SARs).

The agency heads stressed in their joint statement that these obligations cannot be ignored by focusing simply on how particular digital assets are labeled by those who use them. "We are aware that market participants refer to digital assets using many different labels," said the statement, but what is determinative is not labels but rather the "economic reality and use" under "the facts and circumstances underlying an asset, activity or service." "The nature of the digital asset-related activities a person engages in is a key factor in determining whether and how that person must register with the CFTC, FinCEN, or the SEC."

The FinCEN Director made specific reference to FinCEN's May 2019 interpretative guidance, Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies, **FIN-2019-G001 (May 9, 2019)**, to stress that "FinCEN regulations relating to MSBs [money services businesses] apply to certain business models involving money transmission denominated in value that substitutes for currency, specifically, convertible virtual currencies," i.e., cryptocurrencies. Thus, "a number of digital asset-related activities qualify a person as an MSB that would be regulated by FinCEN," such as money transmission services involving use of cryptocurrencies.

The SEC Chairman added that beyond being aware that familiar SEC securities rules are fully applicable to digital assets that qualify as "securities" under federal law, "key participants in the securities markets" such as exchanges, broker-dealers, and investment advisers and companies who are "receiving payments or engaging in other transactions in digital assets should consider such transactions to present similar or additional risks, including AML/CFT risks, as are presented by transactions in cash and cash equivalents." In particular, he noted that broker-dealers and mutual funds, who are considered "financial institutions" for BSA purposes, "are required to implement reasonably-designed AML Programs and report suspicious activity," adding the reminder that these rules "are not limited in their application to activities involving digital assets that are 'securities' under the federal securities laws."

A recent commentator noted that these BSA rules create concern in the crypto space "because cryptocurrency transfers do not intrinsically capture personal identification data." Yaya Fanusie, "The Travel Rule Is Not Enough If Crypto Gets Adopted," Forbes.com (Oct. 30, 2019). Work is being done, however, on various solutions that might "help crypto exchanges to identify users on both ends of a transfer." Id.

Clarifying Which Agencies Regulate What

Given the different federal regulators who assert authority over various kinds of digital assets, Rep. Paul Gosar (R-Az.) has put forth a December 2019 discussion draft for a proposed bill, the "Crypto-Currency Act of 2020," intended to "clarify which Federal agencies regulate digital assets" and require them to notify the public of "any Federal licenses, certifications, or registrations required to create or trade in such assets." The bill does not impose much in the way of substantive rules but essentially just allocates regulatory turf over various kinds of "digital assets" that all "rest on a blockchain or centralized cryptographic ledger," by creating a role called the "Federal crypto regulator" as to each class of digital asset.

Under the bill, this role would be played by the CFTC with respect to "crypto-commodities," which are defined as fungible goods or services that "the markets treat with no regard" to who produced them. FinCEN would be the "Federal crypto regulator" with respect to "crypto-currency" which is defined as "representations of United States currency or synthetic derivatives" that are either "reserve-backed digital assets that are fully collateralized in a correspondent banking account, such as stablecoins," or in the case of synthetic derivatives are "determined by decentralized oracles or smart contracts … and collateralized by crypto-commodities, other crypto-currencies, or crypto-securities." FinCEN also would be required to issue rules to make "crypto-currency" transactions as traceable just like fiat currency transactions are under existing law. Lastly, the discussion draft gives the SEC authority over "crypto-securities," broadly defined as "all debt, equity and derivative instruments" (again, if blockchain-based) except for synthetic derivatives that are "money services businesses" registered with the Treasury Department and which comply with AML/CFT requirements. It is not yet clear, however, how much these proposed roles would meaningfully differ from the authority currently exercised by the SEC, CFTC and FinCEN with respect to various digital assets.

The CFTC's authority over certain digital assets would be expressly recognized in the proposed "CFTC Reauthorization Act of 2019," H.R. 4895 (Nov, 26, 2019), which in §109 directs the CFTC to adopt rules "detailing the content and availability of trade and trader data and other information" relating to certain contract and swap transactions that "reference[] a digital commodity available on a cash market."

More Clarity and Nuance From the IRS

As early as 2014, the Internal Revenue Service (IRS) took the position that "[f]or federal tax purposes, virtual currency is treated as property," and thus "[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency." IRS Notice 2014-21 (April 14, 2014). This position created obvious complications and difficulties in using cryptocurrencies that fluctuate in value (e.g., non-stablecoin cryptocurrencies) for ordinary payments, since every single payment could then theoretically trigger its own tax-reportable gain or loss on the disposition of this "property."

In the summer of 2019, the IRS "begun sending letters to taxpayers with virtual currency transactions that potentially failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions properly." IRS News Release IR-2019-132 (July 26, 2019). These letters, which the IRS announced were being sent to more than 10,000 such taxpayers, stated:

> Virtual currency is considered property for federal income tax purposes. Generally, US taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the US or abroad.

The IRS has since issued further guidance on the tax treatment of certain virtual currency scenarios. On Oct. 9, 2019, the IRS issued Revenue Ruling 2019-24 to address the tax implications of two scenarios: (1) when there is a "hard fork" of a cryptocurrency the taxpayer owns where the taxpayer does not receive units of a new cryptocurrency, and (2) when there is an "airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency," ruling that there is income to the taxpayer in the latter scenario but not the former.

As explained in the revenue ruling:

> A hard fork is unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger.

A well-known example of a hard fork occurred in August 2017, when Bitcoin Cash was created through a hard fork out of the original Bitcoin, allowing Bitcoin holders to either remain with Bitcoin under the existing protocol or move forward with units of the new Bitcoin Cash cryptocurrency under the new Bitcoin Cash protocol. When a hard fork happens, holders who receive the new cryptocurrency may do so through an "airdrop," which the IRS's revenue ruling described as "a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers." Thus, "[a] hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency."

The IRS concluded that there is no income merely from a hard fork of a cryptocurrency alone. If the holder did not receive any units of the new cryptocurrency, the IRS concluded that the holder had no "accession to wealth." However, when there is an airdrop of the new cryptocurrency to the holder as part of the fork, the IRS ruled that the holder has "received a new asset" and thus "has an accession to wealth" resulting in income.

Proposals To Lessen Cryptocurrency Tax Complications

Rather than simply have taxpayers adapt to the potentially burdensome tax implications of the IRS's treatment of cryptocurrency as property, some legislators are introducing proposals to change the IRS's rules. For example, Rep. Ted Budd (R-N.C.) in July 2019 introduced H.R. 3963 (July 25, 2019), the "Virtual Value Tax Fix Act of 2019," which provides that cryptocurrency transactions will qualify as non-taxable "like-kind exchanges" under Internal Revenue Code §1031, with a five-year sunset provision ending at year-end 2024. In April 2019, Rep. Warren Davidson (R-Ohio) introduced the current version of his proposed "Token Taxonomy Act," H.R. 2144 (April 9, 2019), which likewise treats "[a]n exchange of virtual currency … as if such exchange were an [IRC §1031] exchange of real property," and further provides that any gain from the sale or exchange of virtual currencies would be excluded from gross income if "for other than cash or cash equivalents," up to a maximum exclusion of $600 per transaction (to be adjusted for inflation), retroactive to 2017.

In July 2019, before the IRS issued its recent guidance on the tax treatment of hard forks, Rep. Tom Emmer (R-Minn.) introduced the "Safe Harbor for Taxpayers With Forked Assets Act of 2019," H.R. 3650 (July 9, 2019) that would hold individuals harmless for miscalculation of or failures to report gains on cryptocurrency "hard forks" prior to the issuance of IRS guidance or rules on four specified areas relating to hard forks. The recent IRS revenue ruling, however, does not appear to sufficient to satisfy Rep. Emmer's proposed legislation, because it does not appear to address rules for "calculating and allocating the basis of forked convertible virtual currency," "calculating the fair market value of forked convertible virtual currency at any given time," and "determining the holding period of forked convertible virtual currency," as the proposed bill would require in order to end the safe harbor.

Conclusion

There is now little doubt that at multiple levels Washington has become quite attuned to numerous legal, economic and social issues posed by the spread of cryptocurrencies and other digital assets. While new legislation still remains mostly in the proposal stage, regulators and enforcers are already taking action on their own to confront and address some of these issues. Continued activity on this front, including eventually passage of legislation, appears inevitable as the technology matures and new uses emerge.

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