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ON BEHALF OF

THE AMERICAN INSTITUTE OF CPAs

BEFORE

THE UNITED STATES SENATE
COMMITTEE ON FINANCE

HEARING ON

EXAMINING THE TAXATION OF DIGITAL ASSETS

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INTRODUCTION

The American Institute of CPAs (AICPA) appreciates the opportunity to provide written testimony to the Senate Finance Committee to examine the taxation of digital assets. Although the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) have issued guidance on the taxation of digital assets and the reporting requirements for digital asset transactions, taxpayers and tax practitioners still seek clarity and certainty on unresolved or ambiguous digital asset tax-related issues. As the digital asset market expands, it is essential for Congress and regulators to work together to give industry the tools to operate effectively in that market. Further, useful guidance will give taxpayers and tax preparers the clarity needed to make informed, fair decisions regarding their tax obligation.

We understand the difficulty in crafting and tailoring guidance for an asset class that seems to resemble securities in some instances, commodities in other instances, and at times, neither securities nor commodities. Therefore, clearly and consistently defining terms in digital asset tax legislation (and within each section of such legislation where appropriate) will be critical to confirm Congressional intent and ensure certainty to taxpayers, tax practitioners, and the IRS. Furthermore, the use of digital asset transactions and the types of digital assets has evolved rapidly as taxpayers continue to adapt their use of digital assets. This constant evolution combined with the unique nature of digital assets has presented significant challenges in distinguishing the broad array of digital asset classes and determining the appropriate tax consequences. However, the tax system requires certainty and clarity to promote compliance, guarantee fairness, and ensure effective tax administration.

Marking-to-Market for Traders and Dealers (Section 475)

Dealers in securities must use the mark-to-market method for both inventory and non-inventory items. Meanwhile, traders in securities or commodities and dealers in commodities may elect to use the mark-to-market method. Gains and losses for taxpayers that are required to use or may elect to use the mark-to-market method are generally treated as ordinary income or loss.

We recommend that Congress incorporate digital assets into the existing framework under section[1] 475, which would require a dealer of digital assets to use the mark-to-market method and would allow traders of digital assets to elect to use the mark-to-market method to report their income. We further recommend that Congress use existing statutes and regulations to appropriately define the types of digital assets that would be subject to section 475 and clarify the types of activities that would cause a taxpayer to qualify as a dealer in digital assets.

The legislative history underpinning section 475 indicates that mark-to-market accounting was intended to facilitate tax compliance for readily determinable assets by providing a clear reflection of income.[2] Currently, there are many types of digital assets that have readily determinable market values on established digital asset exchanges and, therefore, are not

[1] Unless otherwise indicated, all references to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), and references to a "Treas. Reg. §" are to the Treasury regulations promulgated under the Code.
[2] H.R. Rep. No. 105-148, 105th Cong., 1st Sess. (June 24, 1997).

prone to opportunities for manipulation, thus aligning with the legislative intent of mark-to-market accounting. However, not all types of digital assets are readily tradeable and have established reliable markets. Therefore, only a carefully defined category of digital assets should be eligible for mark-to-mark treatment under section 475.

Section 6045(g)(3)(D) and Treas. Reg. § 1.6045-1(a)(19) generally define the term "digital asset," however, the existing definition would be overly broad for purposes of section 475.[3] Congress should consider specifically defining the types of "digital assets" that would be entitled to mark-to-market treatment under section 475. Treasury Reg. § 1.1092(d)-1 defines "actively traded" and "established financial market" for straddle transaction purposes. However, the existing definition of "established financial market" may not properly encapsulate the categories of digital asset markets. Congress could leverage and tailor the language in Treas. Reg. § 1.1092(d)-1 to properly define actively traded digital assets and to determine the types of digital asset markets for purposes of section 475. For example, S. 2207 (119th Congress), *A bill to amend the Internal Revenue Code of 1986 to reform the treatment of digital assets*, would define "actively traded digital assets" as "a fungible digital asset for which quotations are readily available on a digital asset exchange."

Congress should require dealers of digital assets to use the mark-to-market method to report their activities during the year since the mark-to-market method clearly reflects a dealer's trade or business in buying and selling digital assets in the ordinary course of a trade or business. Currently, section 475(c)(1) provides a definition for "dealer in securities." Congress should review the current section 475(c)(1) definition and consider adding a paragraph defining "dealer in digital asset" for section 475 purposes. Given the unique characteristics of digital assets and the varying types of digital assets, the definition of "dealer in digital assets" would need to clearly identify the types of activities that would cause taxpayers to constitute a dealer. Furthermore, traders of digital assets should be allowed to use the mark-to-market method, similar to the election currently allowed for traders of securities and commodities.

Trading Safe Harbor (Section 864(b)(2))

Section 864(b)(2) generally provides a trading safe harbor from effectively-connected income for trading securities or commodities. The legislative history indicates that the purpose of the safe harbor is to encourage foreign direct investment in United States (U.S.) markets by expanding the circumstances in which a foreign person may trade in U.S. securities and commodities without establishing a U.S. trade or business.[4]

We recommend that Congress consider adding a safe harbor for a subset of digital assets similar to the section 864(b)(2)(A) and section 864(b)(2)(B) safe harbors for securities and commodities, respectively. This would ensure fair treatment of actively traded digital assets and

[3] Section 6045(g)(3)(D) ("Except as otherwise provided by the Secretary, the term "digital asset" means any digital representation of value which is recorded on a cryptographically secured distributed leger or any similar technology as specified by the Secretary"); Treas. Reg. § 1.6045-1(a)(19) ("For purposes of this section, the term *digital asset* means any digital representation of value that is recorded on a cryptographically secured distributed ledger (or any similar technology), without regard to whether each individual transaction involving that digital asset is actually recorded on that ledger, and that is not cash as defined in paragraph (a)(12) of this section").
[4] H.R. Rep. No. 89-1450, 89th Cong., 2d Sess. (1966).

securities and commodities and would provide clear guidance for foreign investors and investment advisors to understand whether their trading activities within the U.S. constitute a U.S. trade or business, which would align with the legislative history of section 864 by encouraging foreign investment in U.S. investment assets.

Similar to our response regarding section 475 above, a definition of "actively traded digital assets" should be developed and referenced for both section 475 and section 864 because not all digital assets have similar characteristics to the securities and commodities being traded on an exchange and currently included in the trading safe harbors under section 864(b)(2). For example, a non-fungible token (NFT) is a type of digital asset under existing statutory and regulatory definitions; however, with the flexibility and creativity in the design of this type of token, an NFT can also represent "collectibles", as well as "right to use" or "fractional ownership" to certain underlying properties. Greater complexity and increased uncertainty may arise if NFTs are included in the safe harbor exemption. Congress should leverage the current definitions under Treas. Reg. § 1.1092-(d)-1 for "actively traded" and "established financial market" to ensure that the scope of actively traded digital assets satisfies the intent of section 475 and section 864.

Treatment of Loans of Digital Assets (Section 1058)

Currently, section 1058 provides nonrecognition treatment for lending activities involving securities if certain requirements are met. This allows taxpayers and tax authorities to identify transactions and apply the proper tax treatment. Furthermore, it allows the lender and borrower to follow formal guidance to set up proper agreements. Without specification, it remains unclear whether digital asset lending activities receive the same treatment as securities lending under section 1058.[5]

Digital assets lending activities have significantly increased as markets have progressively and broadly adopted digital assets. The digital lending activities are functionally analogous to securities lending arrangements. Although there are many different types of digital asset loans, they can be broadly categorized into the following three major categories:

- Taxpayer lends their own digital assets to another taxpayer or organization.
- Taxpayer borrows against their own digital assets.
- Taxpayer borrows digital assets from another taxpayer or organization.

We recommend that Congress amend section 1058 to extend the same nonrecognition treatment applicable to loans of securities to a subset of digital assets. Extension of nonrecognition treatment under section 1058 to digital assets would provide significant certainty to taxpayers and tax practitioners, would enhance tax administration by promoting consistency among tax positions, and would produce the same economic benefits as securities lending. Congress would also need to consider whether the current agreement requirements under

[5] *See* GCM 36948 (prior to enactment of section 1058, IRS advised that securities loan would not result in realization event where identical securities returned).

section 1058(b) could be readily applied to digital asset lending agreements or whether modifications would be needed to integrate digital assets.[6]

For similar reasons as explained in the section 475 and section 864 recommendations above, extension of nonrecognition treatment under section 1058 should apply to a clearly defined subset of "actively traded digital assets." Although any extension of section 1058 to digital assets would practically preclude non-fungible digital assets due to the requirement that identical assets must be returned, explicitly extending treatment to a defined subset of actively traded digital assets would afford clarity and certainty.

Because extension of section 1058 to digital assets would be a nonrecognition event, the economic position of the taxpayer with respect to the digital assets loaned should remain the same before and after the lending transaction. The taxpayer who loaned the digital assets is considered the owner of the digital assets. Therefore, when there is a hard fork, protocol change, or air drop, the taxpayer who is the owner of such digital assets should recognize income. However, this will likely require Congress or Treasury to resolve the outstanding issue of whether income recognition occurs at the time the taxpayer has the right to access the digital assets (i.e., by taking action to access the asset) or at the time the hard fork, protocol change, or air drop occurs, or upon later disposition. The AICPA has recommended in a comment letter addressing Revenue Ruling 2019-24 that the exercise of dominion and control by the taxpayer should determine whether and when the taxpayer must recognize airdropped coins or other unsolicited property as income.[7]

Wash Sales (Section 1091)

The wash sale rule under section 1091 provides that losses will be disallowed when sustained from any sale or disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer acquires substantially identical stock or securities. The rule is not applicable to other financial assets, such as commodities or foreign currency. The rule is also not applicable to dealers in stock if the loss is sustained in a transaction made in the ordinary course of business. Currently, the wash sale rule applies to investments in stock and securities, but not to digital assets.

If Congress extends the wash sale rule to digital assets, the AICPA recommends that Congress except from the general rule dealer dispositions and the use of digital assets for ordinary business transactions. This rule would work in tandem with the extension of mark-to-market

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[6] JCT, *Selected Issues Regarding the Taxation of Digital Assets* (June 2023) ("agreements governing the lending of digital assets, especially through 'decentralized finance' ('DeFi') protocols, are far more diverse than those governing the securities lending").

[7] See AICPA letter, *Comments on Revenue Ruling 2019-24, the New Question on Schedule 1 (Form 1040), and the Internal Revenue Service's Frequently Asked Questions on Virtual Currency Transactions* (Feb. 28, 2020). We note that clarity is needed regarding the timing of recognition of income from a hard fork, protocol change or airdrop, and should tie to a taxpayer action, such as exercise of dominion and control. Our comment letter to the IRS on Revenue Ruling 2019-24 highlighted dominion and control as the date. It did not suggest that later disposition of the asset be the date of income recognition as that was not the focus of the IRS ruling. Specifying a date where a clear action by the taxpayer occurs such as exercising dominion and control over the asset is needed and that such action could also be disposition of the asset although that date likely requires a legislative change such as included in S. 2281, *Lummis-Gillibrand Responsible Financial Innovation Act* (118th Congress).

rules to digital assets because the wash sale rules would not apply to dealers of digital assets using mark-to-market accounting and traders that elect into mark-to-market accounting, which is the current practice for securities dealers and traders.

We also recommend that the existing language in section 1091(a) should apply to any extension to digital assets. Specifically, the language stating that wash sales apply where a taxpayer acquires the asset "by purchase or by an exchange" should continue so that digital assets acquired by mining or staking or other consensus protocol would not trigger the wash sale rule.

Timing and Source of Income Earned from Staking and Mining

The tax treatment for rewards generated from digital asset staking and mining raises challenging questions due to the technology involved, the use of a decentralized system to generate the rewards, and valuation of the rewards. Currently, the IRS takes the position that both staking and mining rewards are "included in the taxpayer's gross income in the taxable year in which the taxpayer gains dominion and control over the validation rewards."[8] There has been at least one challenge to the IRS's position where the taxpayer argued that the staking reward should be taxed upon disposition due to its nature as "self-created property."

Due to the challenges in characterizing and valuing staking and mining rewards and the persuasive arguments on each side, Congress should determine the tax consequences of staking and mining rewards and offer certainty to taxpayers and tax practitioners.

If Congress determines that staking and mining rewards are taxed upon receipt as ordinary income, the source of such income should be determined by the recipient's residence. If Congress determines that staking and mining rewards are taxed upon disposition by the staker or miner, the source of such income should be determined under general tax principles by reference to the recipient's residence.

When Congress addresses the tax consequences of staking and mining rewards, it should also consider addressing the following issues that need clarification:

- The timing and character of any income from rewards.
- Clarify the definitions of staking and mining, as well as the types of activities that may constitute staking and mining, including delegated staking and participating in mining pools.
- For purposes of section 469, whether the rewards should be treated as portfolio income or trade or business income (with existing section 469 rules applied to determine if the trade or business income is active or passive).
- Using the existing definitions of "trade or business," whether an individual involved in mining or staking is in a business.

[8] Rev. Rul. 2023-14. *See also* Notice 2014-21 (fair market value of digital asset mining reward is includible in gross income as of date of receipt).

- The specific documentation required for mining and staking activities.

Nonfunctional Currency (Section 988(e))

Today, most individuals acquire and trade digital assets for investment or business use. The use of digital assets for personal transactions (e.g., an individual using a digital asset to buy coffee or vacation services) is not common but may increase as more individuals own digital assets or with any increase of stablecoins. These personal transactions will likely have nominal gains or losses, with any losses unusable per section 165(c) since they are not from investment or business uses.

We recommend that Congress consider adding a provision to the Internal Revenue Code that applies a *de minimis* nonrecognition rule for digital assets used in personal transactions, which would be similar in effect to section 988(e)

Section 988(e) excludes gains realized from personal transactions involving foreign currency that may have changed in value from when the individual acquired such currency to the time when used for a personal purchase. This nonrecognition rule appears to be a matter of tax administrative convenience for transactions with nominal tax impact, and the nonrecognition rule is limited to a gain of $200 or less. Allowing the individual to exclude any gain of $200 or less from personal purchases made with digital assets (as defined at section 6045(g)) would align with the intent of section 988(e) and serve as an administrative convenience for taxpayers, tax practitioners, and the IRS.

The exclusion should be added to Subtitle A, Chapter 1, Subchapter B, Part III, items specifically excluded from gross income, rather than added at section 988 because cryptocurrency is not treated as a foreign currency.[9] The provision could be added as new section 139M. An example of this type of provision is proposed in S. 2207, except that such bill includes a $300 threshold and an annual maximum gain exclusion of $5,000.[10] Although we express no opinion on a maximum annual exclusion, we support incorporating an aggregation rule that treats any series of related sales, exchanges, or dispositions of digital assets as a single sale, exchange, or disposition for purposes of this new provision (such as included in S. 2207).

If taxpayers use an exchange/broker as defined under section 6045 for the purchase of a personal use item, the sales price and basis may be reported to the taxpayer and the IRS on Form 1099-DA, *Digital Asset Proceeds From Broker Transactions*. To make it relatively easy for the taxpayer to remove gains under a new section 139M, the IRS could provide a specific code for the proposed section 139M exclusion that taxpayers could use on Form 8949, *Sales and Other Dispositions of Capital Assets*, to remove the excluded gain if the gain from the personal use transaction was $200 or less.

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[9] Notice 2014-21, *modified by* Notice 2023-34.
[10] S. 2207, *A bill to amend the Internal Revenue Code of 1986 to reform the treatment of digital assets,* section 2(a) (119th Cong.).

Congress would also need to consider appropriate definitions and recordkeeping requirements. Section 988(e)(3) provides a definition of "personal transactions" that Congress could leverage for proposed section 139M if it would be consistent with Congressional intent in enacting a *de minimis* nonrecognition rule for digital assets. Section 988(e)(3) provides that a personal transaction is any transaction entered into by an individual, except expenses allocable to most trade or business expenses under section 162 or expenses for the production of income under section 212. Regarding recordkeeping requirements, Congress, as well as Treasury when implementing the law, should consider the need to minimize the tax administrative burden and to maximize the amount of clarity for taxpayers, tax practitioners, and the IRS (e.g., the "books and records" and "regulations and guidance" provisions in S. 2207).

Valuation and Substantiation (Section 170)

Generally, a taxpayer claiming a charitable contribution deduction for property valued at more than $5,000 must obtain a qualified appraisal. Section 170(f)(11) provides an exception to the appraisal requirement for "readily valued property," which includes contributions of cash, qualified vehicles, certain intellectual property, and publicly traded securities. Many types of digital assets are actively traded on digital asset exchanges and, therefore, have readily determinable values similar to publicly traded securities. However, actively traded digital assets are currently not eligible for the qualified appraisal exception under the statute's plain language.[11]

We recommend that Congress amend section 170(f)(11) to include "actively traded fungible digital assets" in the category of readily valued property.

The rationale of the qualified appraisal exception is that the prices for publicly traded securities are available on established exchanges, thus not requiring a qualified appraisal. Despite some unique characteristics of digital assets and the broad array of types of digital assets, the reasoning underpinning such exception applies equally to publicly traded securities and certain digital assets, namely digital assets for which market quotations are readily available. Thus, a taxpayer donating an actively traded fungible digital asset (e.g., Bitcoin) worth more than $5,000 should be subject to the same charitable contribution deduction substantiation rules as a taxpayer donating publicly traded securities (e.g., Apple stock). Extending the qualified appraisal exception to taxpayers that make charitable contributions of actively traded digital assets ensures that similarly situated taxpayers are treated similarly. Not only would such change promote fairness, it would reduce the tax compliance burden associated with charitable giving of non-cash assets and further facilitate charitable contributions.

As mentioned above in the discussion of section 475 and section 864, clear and certain guardrails could be placed around the extension of section 170(f)(11) to digital assets by defining the subset of digital assets eligible for the exception and determining the acceptable types of digital asset markets. The extension of section 170(f)(11) to digital assets should apply to actively traded fungible digital assets. Non-fungible tokens are more likely to not have an established liquid market and introduce opportunity for abuse. Ultimately, a carefully tailored

[11] *See also* CCA 202302012 (Jan. 10, 2023) (donations of digital assets did not qualify for qualified appraisal exception).

definition of actively traded digital assets should alleviate any concern for abusive charitable contributions. In determining the definition of "actively traded" for digital assets, Treas. Reg. § 1.1092(d)-1 can be leveraged only as an example in defining "actively traded" because the definition of "actively traded" under Treas. Reg. § 1.1092(d)-1, as it is currently written, does not neatly fit with digital assets. In defining "actively traded," Congress could consider whether the digital asset is listed on an established market (e.g., more than one centralized exchange where the exchange(s) are regulated in the U.S.). Additionally, Congress could consider other factors such as trading volume, trade frequency, and liquidity to ensure that the qualified appraisal exception is only utilized for the appropriate types of digital assets.

Additionally, due to the ability to transfer digital assets instantaneously and at any time, Congress should consider clarifying when a charitable contribution of digital assets occurs for valuation purposes.

Worthless Asset Losses (Section 165(g))

Section 165(g) provides that worthless securities are treated as a capital loss from the sale or exchange of a capital asset on the last day of the tax year. Generally, individuals may only use capital losses against capital gains plus up to $3,000 of ordinary income, with any excess capital loss carried forward. Without this provision, a worthless capital asset would generate an ordinary loss because a capital loss only results from the sale or exchange of a capital asset (per section 1222). The capital loss treatment for worthless securities yields a more favorable tax treatment because an ordinary loss is only allowed as a miscellaneous itemized deduction (and not allowed as a deduction at all starting in 2018).[12] For a worthless capital asset other than a security as defined at section 165(g)(2), the result is that the loss is not allowed. For assets held for investment and treated as capital assets under section 1221, it seems that gains and losses should be treated similarly. This is not the case today for digital assets.

Congress should consider whether section 165(g) should incorporate digital assets to cover additional types of worthless capital assets, such as digital assets held for investment.

Concluding Remarks

The AICPA understands the challenges that Congress faces as it tackles the complex issues inherent in drafting digital asset tax legislation. The digital asset industry and our tax system would benefit greatly by having Congress address many of the issues discussed in this testimony. Further, legislation that addresses the application of existing tax principles to digital assets would give industry and taxpayers the necessary tools to operate effectively in the digital assets market. We look forward to working with the 119th Congress, this Committee, and the tax-writing committees as Congress continues to address digital asset taxation.

[12] *See* CCA 202302011 (Jan. 13, 2023) (tax treatment of worthless digital assets). *See also* sections 62, 63, and 67.

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