McGuireWoods

Cryptocurrency 101

Introduction for Lawyers

CLE Presentation

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McGuireWoods Speakers

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Agenda

- Major Types of Crypto Assets
- Regulatory Viewpoints
- Potential Implications for Accepting Cryptocurrency Payments
- Questions
  - Please use the Q&A chat feature on your platform to pose your question to our speakers.

What is Cryptocurrency?

- Friendly advice: do not get caught up trying to understand how it works; focus on what it does.
- Cryptocurrencies are based on blockchain technology.
- A blockchain consists of a string of blocks (groups of transactions) aligned in chronological order based on the order of transactions.
- Subsequent blocks added to the blockchain always refer to the previous blocks and each contain a copy of the full, updated ledger.
- “Timechain” is another way to think of how a blockchain works.
- The more users running the cryptocurrency software, the more users with the ledger of all transactions, the more decentralized the cryptocurrency becomes.

Overview: Major Types of Crypto Assets

- Cryptocurrencies
  - Decentralized digital currencies that can be sent peer-to peer without the need of an intermediary. Transactions are verified by the network and recorded in a public distributed ledger called a blockchain.
  - Examples: Bitcoin, Ethereum.

"[T]wo people, anywhere in the world with an internet connection.. [can] make a transfer of value in a few minutes without any middleman."

Wall Street Journal, "What Is Cryptocurrency, and How Does it Work?," Paul Vigna, December 2, 2021

Overview: Cryptocurrency

- Cryptocurrencies have risen in popularity over the past decade and becoming mainstream.
- Starting to see features in various financial service activities — like payment and investment transactions.
  - Potential benefits of faster deposits
  - Faster wire transfers
  - Investment opportunities

Overview of Crypto Assets

Digital Asset	Symbol	Approved for Custody	Approved for Listing
0x	ZRX	X	
Aave	AAVE	X	X
Bancor Network Token	BNT	X	X
Basic Attention Token	BAT	X	X
Binance USD	BUSD	X	X
Bitcoin	BTC	X	X
Bitcoin Cash	BCH	X	X
Chainlink	LINK	X	X
Dogecoin	DOGE	X	
Ethereum Classic	ETC	X	
Ethereum	ETH	X	X
Gemini Dollar	GUSD	X	X
GMO JPY	GYEN	X	X
Kyber Network	KNC	X	
Litecoin	LTC	X	X
Livepeer	LPT		X
Lumens	XLM	X	
OmiseGO	OMG	X	
Pax Gold	PAXG	X	X
Pax Dollar	USDP	X	X
Ripple	XRP	X	
Synthetix	SNX		X
Wrapped Bitcoin	wBTC	X	
Z.com USD	ZUSD	X	X

Example:

[Greenlisted Coins/Tokens | Department of Financial Services (ny.gov)]

Non-Fungible Tokens (NFTs)

Non-Fungible Tokens (NFTs)

Non-fungible tokens (NFTs) are unique digital tokens that offer authenticity and proof of ownership of a reproducible digital file such as artwork, music, or a video. NFTs are stored on public blockchains like Ethereum.

Even if you own the NFT, you do not control the digital art/IP.

Set sail for adventure! (Image credit: Republic Realm)

[Someone bought a $650,000 NFT yacht for a game that hasn't been released | PC Gamer]

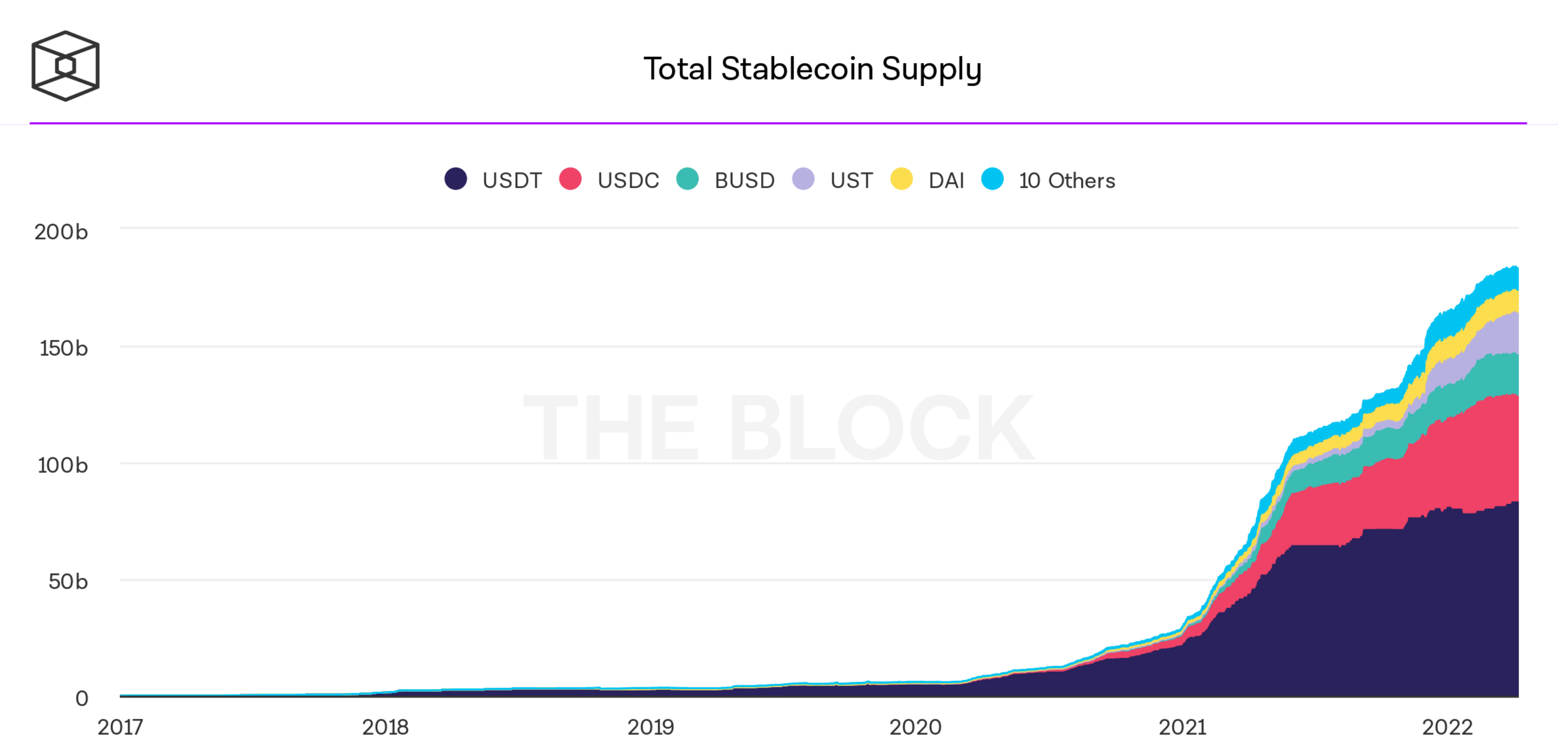
Stablecoins and Central Bank Digital Currencies

- Stablecoins
  - Digital currencies pegged 1-1 to a fiat currency, commodity (such as gold), or cryptocurrency that can be redeemed from the issuer for the underlying asset (such as the U.S. dollars).
  - Algorithmic stablecoins use specialized algorithms and smart contracts that manage the supply of tokens in circulation to track the value of a fiat currency
  - Most stablecoins are pegged to the U.S. Dollar
  - Examples: Tether, USDC
- Central Bank Digital Currencies
  - Digitized versions of fiat currency like a nation's currency
  - Example: Digital Yuan (in development), U.S. CBDC (under consideration pursuant to Biden executive order, which is discussed *infra*)

Stablecoins and Central Bank Digital Currencies

The total supply of stablecoins has increased rapidly over the past two years.

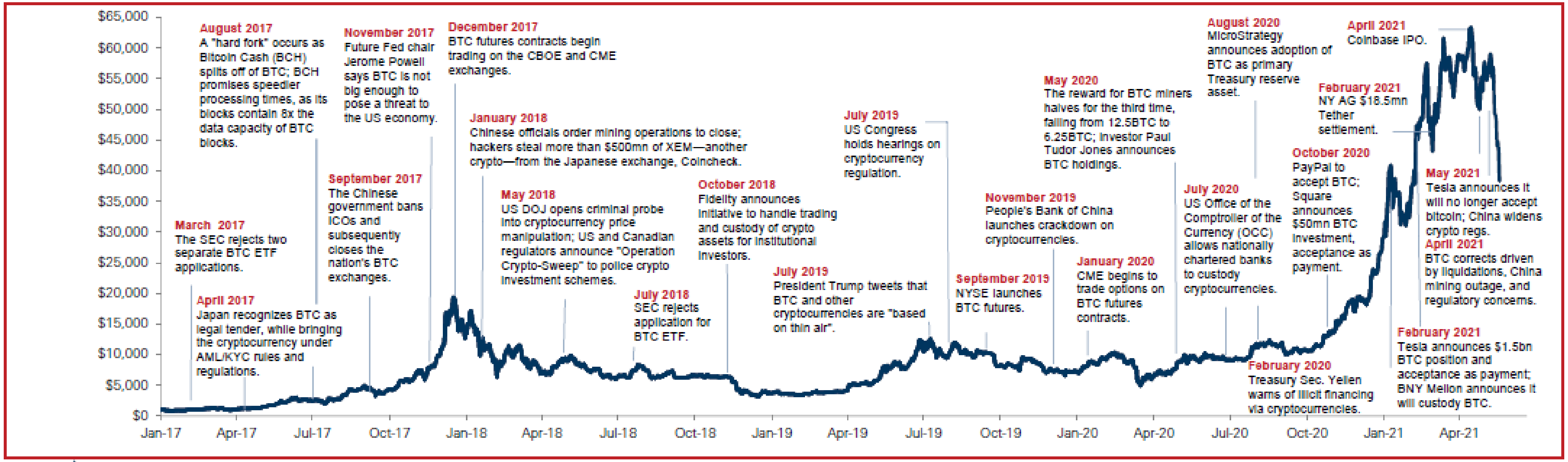
There is currently approximately $184 billion in outstanding stablecoins. The two biggest are USDT (Tether, $83 billion) and USD Coin (USDC, $45 billion)



SOURCES: THE BLOCK, COIN METRICS
UPDATED: APR 10, 2022

Bitcoin Market Pricing and Events of Note

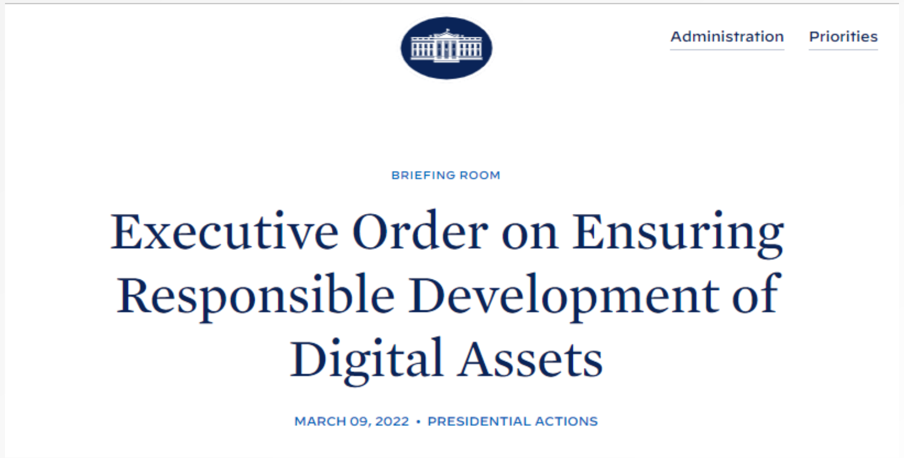
2017-2021



Impacted Industries

- Energy Sector
  - Certain networks, such as the Bitcoin network are very energy intensive.
  - Miners are incentivized to seek out cost-friendly sources.
  - Developing regulatory landscape.
- Banking Industry
  - Opportunities but inherently volatile market – risky for investors
  - Unclear and changing regulatory landscape
  - BSA/AML compliance issues

Recent Updates – Executive Order



- On March 9, 2022, President Biden signed an Executive Order on Ensuring Responsible Development of Digital Assets ("Executive Order") to mobilize the federal government to develop a strategy for digital assets, intending to encourage innovation but mitigates the risks to consumers, investors, and businesses.
- The Executive Order mandates an interagency approach across several executive departments and federal departments and agencies to conduct reports and analyses on key issues impacting digital assets, including consideration of a U.S. Central Bank Digital Currencies ("CBDC").

The Executive Order identifies six primary policy objectives:

1. protect U.S. consumers, investors, and businesses;
2. protect U.S. and global financial stability and mitigate systemic risk;
3. mitigate the illicit finance and national security risks posed by misuse of digital assets;
4. reinforce U.S. leadership in the global financial system and in technological and economic competitiveness;
5. promote access to safe and affordable financial services; and
6. support technological advances that promote responsible development and use of digital assets.

Executive Order: Position on a U.S. Central Bank Digital Currencies

- The Executive Order sets forth the Biden Administration's policy on a U.S. CBDC, which places "the highest urgency on research and development efforts into the design and deployment options of a United States CBDC." The Executive Order requires an analysis of:

1. the potential implications of a U.S. CBDC, based on the possible design choices, for national interests, including implications for economic growth and stability;
2. the potential implications a U.S. CBDC might have on financial inclusion;
3. the potential relationship between a CBDC and private sector-administered digital assets;
4. the future of sovereign and privately produced money globally and implications for our financial system and democracy;
5. the extent to which foreign CBDCs could displace existing currencies and alter the payment system in ways that could undermine U.S. financial centrality;
6. the potential implications for national security and financial crime, including an analysis of illicit financing risks, sanctions risks, other law enforcement and national security interests, and implications for human rights; and
7. an assessment of the effects that the growth of foreign CBDCs may have on U.S. interests generally.

Money and Payments: The U.S. Dollar in the Age of Digital Transformation

The Executive Order echoes many of the themes outlined in the Federal Reserve's discussion paper published in January 2022 on the U.S. Dollar in the Age of Digital Transformation

The Fed provides its initial analysis on the potential adoption of a U.S. CBDC and invites the public and other stakeholders to provide their views.

The paper explores existing forms of money in the U.S., the current state of the U.S. payment system, and various digital assets that have emerged in recent years, including bitcoin and stablecoins. The focus then shifts to CBDCs, including their uses and functions, their potential benefits and risks, and related policy considerations.

Regulatory Viewpoints: SEC

- The Securities Exchange Commission (SEC) regulates the trading of securities. Crypto assets that are securities must be registered with the SEC. Only Bitcoin has been deemed to be not a security.
- SEC Chairman Gary Gensler has called cryptocurrency the “Wild West” of finance and has stated that the asset class is “rife with fraud, scams, and abuse in certain applications” and has suggested many, if not most, crypto assets are securities, including stablecoins.
- The legal test for determining whether an asset is a security is a fact-driven analysis under *SEC v. W.J. Howey Co.* Crypto lending products are analyzed under *Reves v. Ernst & Young*.
- The current focus of the SEC:
  - Crypto exchanges offering unregistered securities.
  - Crypto lending programs in which customers are paid a yield, discount, or interest in connection with the underlying asset.

Regulatory Viewpoints: SEC

- In February 2022, the SEC charged crypto exchange, Blockfi with failing to register its crypto lending product and failing to register as an investment company.
- In 2015, the SEC charged two Bitcoin mining companies and their founder with conducting a Ponzi scheme by offering shares in a purported bitcoin mining operation. However, neither company had the capability to engage in large-scale mining. Investors paid for a share of computing power that never existed.
- In November 2021, the SEC subpoenaed documents and communications from a bitcoin mining company relating to the company's data center facility.

BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of its Crypto Lending Product

Company also agrees to attempt to bring its business into compliance with the Investment Company Act of 1940 within 60 days

FOR IMMEDIATE RELEASE
2022-26

SEC Charges Bitcoin Mining Companies

FOR IMMEDIATE RELEASE
2015-271

Washington D.C., Dec. 1, 2015 — The Securities and Exchange Commission today charged two Bitcoin mining companies and their founder with conducting a Ponzi scheme that used the lure of quick riches from virtual currency to defraud investors.

Marathon Receives SEC Subpoena Related to 2020 Hardin Data Center Agreement; Shares Tumble

The bitcoin miner's shares plummeted 27% on Monday, significantly underperforming other crypto miners.

By Aoyon Ashraf · Nov 15, 2021 at 1:40 p.m. EST · Updated Nov 15, 2021 at 4:13 p.m. EST ·

Regulatory Viewpoints: The Fed

- *"If [stablecoins] are going to be a significant part of the payments universe — which we don't think crypto assets will be, but stablecoins might be — then we need an appropriate regulatory framework, which frankly we don't have."*

  – Federal Reserve Chairman Jerome Powell in testimony to House Financial Services Committee, July 14, 2021

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

November 23, 2021

Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps

The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency (collectively, agencies) recognize that the emerging crypto-asset sector presents potential opportunities and risks for banking organizations, their customers, and the overall financial system.[1] As supervised institutions seek to engage in crypto-asset-related activities, it is important that the agencies provide coordinated and timely clarity where appropriate to promote safety and soundness, consumer protection, and compliance with applicable laws and regulations, including anti-money laundering and illicit finance statutes and rules.

[Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps (federalreserve.gov)]

Regulatory Viewpoints: FinCEN

- The Financial Crimes Enforcement Network (FinCEN) included virtual currency in its June 2021 statement of priorities. FinCEN wants to combat the use of cryptocurrencies to fund terrorism, money laundering, and other criminal activities.
- Section 6102(d) of the Anti-Money Laundering Act of 2020 expanded the definition of "financial institutions" to include businesses involved in the exchange of "value that substitutes for currency or funds," and codified FinCEN's longstanding position that cryptocurrency exchanges—which convert fiat currency such as the U.S. dollar into cryptocurrency and vice versa—are "money services businesses."

Regulatory Viewpoints: CFTC

- The U.S. Commodity Futures Trading Commission (CFTC) regulates the trading of derivatives on commodities that are not securities as well as certain retail commodity transactions involving digital assets such as cryptoassets including cryptocurrencies.
- The Chairman Heath Tarbert stated that he believes the cryptocurrency Ether is a commodity within the jurisdiction of the CFTC signaling a potentially significant development for market participants.
- However, a gap remains in the regulation of the trading of crypto in the cash market.
- Eliminate Barriers to Innovation Act of 2021 passed the House on April 20, 2021, and would mandate the creation of a joint working group of private sector employees that would advise the SEC and CFTC and bring recommendations as to how the commissions should address digital assets markets.

Potential Implications for Accepting Cryptocurrency Payments

- Avoid money transmission issues (use of a vetted and licensed third party usually resolves these concerns). Additional legal analysis should be undertaken before accepting cryptocurrency as payment.

bitpay

SPEDN

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These are representative examples of third parties and not a recommendation or endorsement. Any third party provider should be reviewed and vetted.

Taxation of Cryptocurrency

- Federal and state taxing authorities are laser focused on the regulation and taxation of cryptocurrency transactions.
- Greater need for tax guidance now that cryptocurrency is more regularly traded and individuals and enterprises are using it to transact business.
- The current IRS Priority Guidance Plan for 2021-2022, includes as its focus:
  - (i) general guidance concerning “virtual” currency; and
  - (ii) regulations regarding information reporting on virtual currency.
- Additionally, several states have expanded liability for under-reporting to extend to accountants, lawyers, and other tax professionals who knowingly or recklessly cause taxpayers to under-report the tax they owe from cryptocurrency transactions.
- The OECD has also been working to create a new Common Reporting Standard (CRS) that specifically addresses virtual assets.

Taxation of Cryptocurrency

- Published IRS Guidance
  - Notice 2014-21: Convertible virtual currency is treated as property (not currency), with general principles applicable to property transactions applying
  - Revenue Ruling 2019-24: Confirms that taxpayers have income (a taxable event) when they have “complete dominion” over units of cryptocurrency
  - IRS FAQs (October 9, 2019): A set of “frequently asked questions” relating to virtual currency transactions, expanding from the original 16 “questions and answers” found in Notice 2014-21, updated regularly
  - CCA 202114020 (March 22, 2021): Clarifies Revenue Ruling 2019-24 and provides example of Bitcoin’s hard fork with Bitcoin Cash

Taxation of Cryptocurrency: Classification/Timing/Computation

Classification Issues
- Currency
- Payment method
- Property
- Commodity
- Security
- Intangible Asset

Timing Issues
- Mining
- Earning
- Storage
- Spending
- Sale/Exchange
- Loss/Theft

Computational Issues
- Tax Basis
- Cost Basis (item-by-item/pool)
- Valuation
- Ordinary Income/Capital Gain
- Long-term/short-term gains

Other Issues
- Tax Compliance
- Sourcing Rules
- Withholding
- Tax Treaties
- Derivatives, etc.

Taxation of Cryptocurrency: Open Tax Issues and Challenges

Blockchain technology poses challenges for the application of existing tax law, including the following:

- What is the source of the income? U.S. or foreign? If U.S., which State(s)?
- What is the character of the income? Purchase price? Income for services? Royalty? Sale?
- How is staking and mining taxed?
- What is the timing of the recognition of income in a given blockchain transaction?
- What are the tax consequences for token issuers in an initial coin offering (“**ICO**”)?
- What are the tax consequences for token purchasers when they use a token?
- Which jurisdiction to be used for an ICO(U.S. vs. Foreign)?
- What are the tax implications on Crypto Lending Transactions?
- What are the tax consequences of various aspects of blockchain technology, such as hard forks, soft forks, and air drops?
- What are the reporting requirements?

Taxation of Cryptocurrency: Taxable Events

Taxable transactions involving virtual currencies include:

- An exchange of virtual currency for goods or services;
- A sale of virtual currency;
- An exchange of virtual currency for other property, including for another virtual currency or fiat currency; and
- The receipt or transfer of virtual currency for free (without providing any consideration), including from an air-drop or a hard fork transaction

Taxation of Cryptocurrency: Taxable Events cont.

Key recognition events

- Receipt of virtual currency in exchange for goods/services
  - If you receive virtual currency in exchange for services or goods, you include the FMV of the virtual currency in gross income, measured in USD, as of the date that the virtual currency was received. Subsequent transactions utilizing the virtual currency will generally follow the capital gain/loss rules (if virtual currency is held as a capital asset).
  - The basis the Taxpayer has in the virtual currency is FMV as of the date of receipt.
- Receipt of virtual currency in exchange for compensation
  - If you pay an employee with virtual currency as compensation for services rendered, the employee will report the income as W-2 wages on its tax return and the company will receive a compensation deduction. The payment will be subject to traditional employment taxes (FICA/FUTA).
  - Individuals may also be subject to self-employment income taxes (if applicable).

Taxation of Cryptocurrency: Taxable Events cont.

Key recognition events

- Receipt of virtual currency in exchange for other property or services
  - May have gain or loss on the transaction if the value of the property or services received is different than the basis the Taxpayer has in the virtual currency.
- Character of gain or loss
  - The character of the gain or loss in a sale or exchange generally depends on whether the virtual currency is treated as a capital asset in the hands of the taxpayer.

Federal Tax Compliance and Reporting

- Area of top focus for Department of Treasury, IRS and many States
  - Taxpayers must report income, gain, or loss from all taxable transactions involving virtual currency on their federal and state income tax return for the taxable year of the transaction, regardless of whether the taxpayer received a payee statement (e.g., Form W-2 or Form 1099) during that year.
  - Rules around individual tax compliance have been published, but guidance with respect to corporate/entity tax compliance has yet to be released
  - In compliance with Section 6050W, payment processors (third-party settlement organizations) are required to report the gross amount of reportable transactions for payees that use their network, provided that, the payee’s reportable transactions exceed $20,000 and the aggregate number of those transactions exceeds 200.
  - Watch out for the John Doe summons, the IRS pursued John Doe summons against multiple cryptocurrency exchanges (e.g., Kracken and Coinbase).

State and Local Tax Compliance and Reporting

- The majority of states have provided no guidance on the taxation of digital assets. There is significant uncertainty here.
- Questions to consider:
  - Income tax nexus (through the amount of sales of tokens to investors within a state or through relationships with minders, validators, and/or nodes in a state)?
  - Sales tax implications?
  - New state and local crypto tax incentives to attract new tech/crypto businesses to states?
    - E.g., Kentucky
  - Unclaimed property considerations?
    - Broadening application of unclaimed property laws to cover virtual currencies

Questions or Comments?

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