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What's the thing?

A tax lens on the proliferation of digital assets

InFocus: Small details have a big impact

Top takeaways



We are witnessing a proliferation of digital assets across geographies and industries, from cryptocurrencies to tokens to stablecoins to a digital representation of everything along with derivatives of each. While blockchain technology serves as a catalyst for this dynamic, allowing use cases to grow in number and transaction volumes to increase, there is relatively little tax guidance on point.



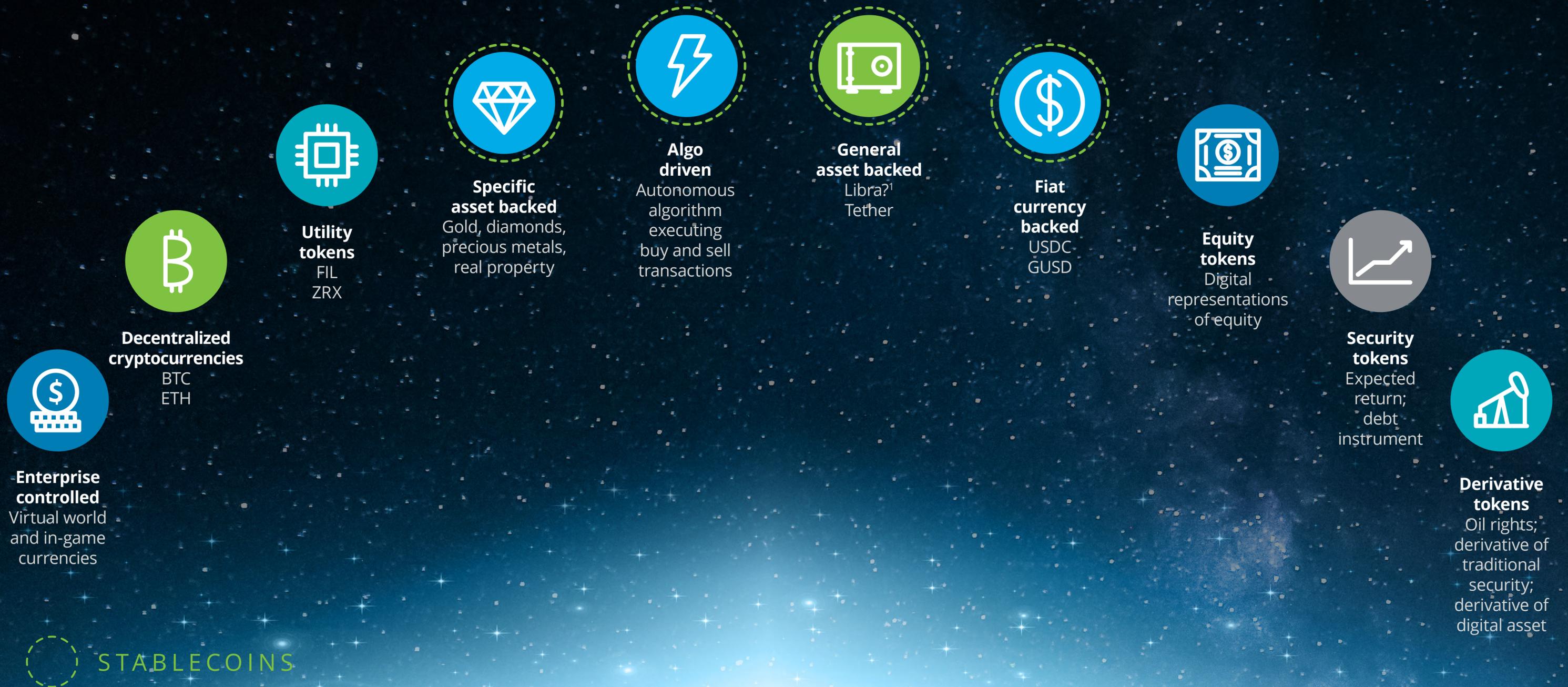
It is important to apply a tax lens to the digital assets being used in business; it frequently differs from the analysis used for accounting and broader regulatory purposes.



The details surrounding each digital asset matter. We find ourselves asking the question: *"What's the thing?"* when evaluating these assets because details inform the asset's character, basis tracking, application of indirect tax, revenue and expense recognition, and sourcing.

Business communities around the world are buzzing with all sorts of crypto-discussions triggered by blockchain projects. In a very short period of time, we've evolved from cryptocurrencies to tokens to stablecoins to a digital representation of everything along with derivatives of each. While the blogosphere may not be the best source of reliable information on the tax treatment of these new asset types, it is fair to say that we are witnessing a proliferation of digital assets across geographies and industries (figure 1).

Figure 1. Proliferation of digital assets



Each day blockchain technology sees more business models and use cases, inspiring innovative forms of fundraising, providing access to platforms, facilitating new payment methods, verifying digital identities, and enabling new types of commerce. Yet even as digital asset use cases grow in number and transaction volumes increase, there is relatively little tax guidance on point.

Bitcoin and other digital asset types present new and novel US federal income tax issues. IRS guidance is limited to Notice 2014-21, 2014-1 C.B. 938 that defines virtual currency as “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value,” which is treated as property for federal income tax purposes.² Many digital asset-based transactions are treated as a barter exchange for US income tax purposes, thus frequently triggering gain or loss. Other non-US tax regulators have issued guidance involving direct and indirect tax but the landscape remains unclear.³

Think uniquely about each asset type



The details surrounding each digital asset greatly impact what that asset represents under various regulatory frameworks, especially tax. While the terminology in this space is increasingly misused and overgeneralized, it is important to think uniquely about each asset type and its relevant tax treatment.

Without clear guidance, taxpayers will need to analyze the specific details surrounding each transaction and digital asset type and draw analogies to existing tax guidance.

For example, the concept of a token may inspire memories of arcade games where you would exchange your dollars for tokens and then again for entertainment. These tokens were only honored by the issuing arcade and represent prepaid service revenue. Today's virtual video games still issue tokens, but to the extent that they are controlled by the game, these "**controlled tokens**" represent a prepayment for services, recognized as

deferred revenue and governed by Rev. Proc. 2004-34 and now Section 451(c). This concept was addressed by the Government Accountability Office in a 2013 report titled *Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks* ("the GAO report") in which the GAO describes a "closed flow" virtual currency system where virtual currency can be used only within a game or virtual environment to purchase virtual goods or services within a game. The GAO report describes how virtual tools amassed by players can be traded in a game for other in-game assets or to advance to higher play levels, but they hold no value outside of the game and cannot be cashed out for dollars or other government-issued currencies. The GAO report also provides an example of a transaction in a closed flow system that may not trigger tax to the user.

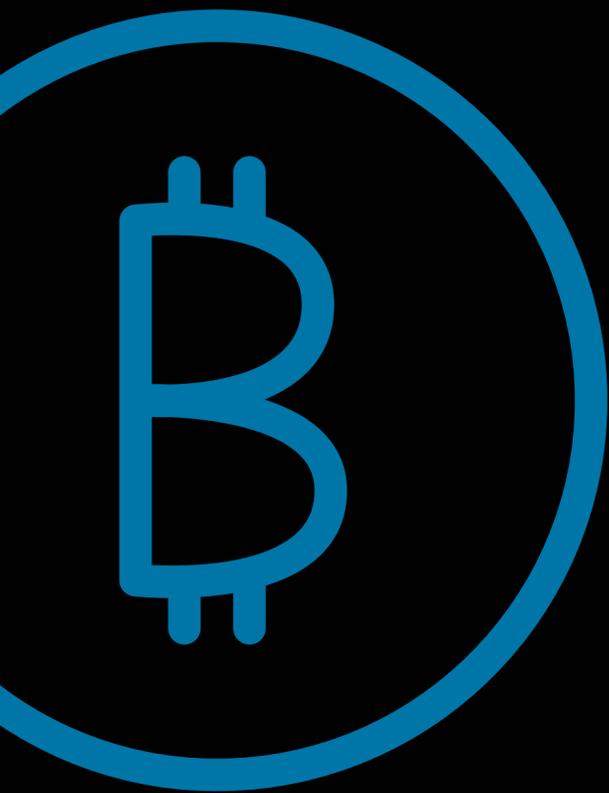




Decentralized cryptocurrencies, which are specific or “native” to a public decentralized protocol, have been deemed “property” by many regulators, including the IRS.

These differ from the game tokens discussed above because they often carry additional rights or properties, can be transferred between parties as a means of exchange, and are convertible to fiat currency or other property. Many of these cryptocurrencies are also referred to as a “store of value.” The property’s tax treatment will vary by the user, its purpose for being held, and the rights attributable to the holder. With little tax guidance on point, practitioners may find themselves building analogies to traditional tax concepts in the Internal Revenue Code, Treasury regulations, and appropriate caselaw.

Asset-backed tokens can represent fiat currency, diamonds, gold, precious metals, baskets of assets, or even fractional interests in real estate. Some are a digital representation of a specific asset, while others represent a right to claim an asset. Many of these asset-backed tokens are referred to as **stablecoins**. Other stablecoins may be governed by an algorithm, influencing buy and sell-side transactions to reduce the amount of volatility but without the asset-backing. The tax treatment of each of these digital assets may differ depending upon its properties, such as what rights are given to holders and how they can be used. The intentions of some stablecoins are to merely represent the underlying property supporting the asset such that the exchange of the stablecoin is just a digital representation of the transfer of the underlying assets.





One complexity of this model comes from having the buyer, the seller, and the underlying assets in potentially three different jurisdictions—all of which may assert tax on an amount of gain triggered by the transfer or potential nexus, permanent establishment, informational reporting, indirect tax, or withholding tax considerations. Further, there are different basis tracking rules for securities, commodities, or other assets for tax purposes, and these rules also vary based upon the jurisdiction. By contrast, the stablecoin could be deemed property separate and distinct from the underlying assets, which may raise questions about the tax treatment to the issuer as well as the holder.

The phrase “**utility token**” gained popularity in the initial coin offering boom but is still a useful designation, signifying when a token can be used to access a platform or interact with a smart contract, allowing real-time revenue splits. Similarly, “**security token**” has become a

popular designation in reference to securities laws, but it is important to note that the definition of “security”—and its tax treatment—may change depending upon its characteristics and the applicable tax authority (i.e., Internal Revenue Code, Treasury regulations, and caselaw). For instance, we are seeing an increasing number of **equity tokens**, many of which are intended to represent digitized equity in a company and could be referred to as a security token for SEC purposes. The United States has a long history of litigation surrounding what is and what is not considered equity for tax purposes. Therefore, any added functionality of equity tokens beyond pure equity should be analyzed carefully regarding potentially influencing its treatment as an alternative form of property for tax purposes. By contrast, there are a number of SEC-designated security tokens associated with tokenized business models that would not be considered equity for tax purposes.



Why details matter



It is important to apply a tax lens to the digital assets being used in business as it frequently differs from the analysis used for accounting and broader regulatory purposes. And because tax is very fact-specific, the details surrounding each digital asset can make a big difference. Some are looking at traditional financial instrument models, pulling out the word “fiat” or “security,” and inserting . . . “a thing”. We need to pause and acknowledge that this thing is a digital asset of some kind and that its tax treatment may not be the same as traditional financial instruments.

Consider starting with the question **“What’s the thing?”** when evaluating digital assets because details inform the tax classification of the asset, its character (capital vs. ordinary), appropriate basis tracking methods, the application of indirect tax (e.g., sales tax, VAT), revenue recognition, and where any resulting revenue is sourced.

With little authoritative tax guidance on point, careful analysis is required.

The specifics of the digital asset could also drive structuring considerations using partnerships, corporations, and trusts as well as cross-border transactions.

The increased volume of transactions enabled by digital assets is creating a complex world of barter transactions and causing entire ecosystems to come into existence without ever reverting back to fiat currency. There are infrastructure providers to help us track basis, enable analytics, and gain comfort about custody. At the end of the day, it is important to remember that all digital assets are not created equal and small details can have a big impact on their tax treatment.



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Endnotes

1. Preliminary based on information available.
2. Calvin, Jim, *Taxation of Cryptocurrencies*: Bloomberg Tax Management Portfolio No. 190, 2019; citing Notice 2014-21, § 4, Q&A-1
3. *Understanding Digital Tokens: Legal Landscapes Governing Digital Tokens in the United States*, Chamber of Digital Commerce and the Token Alliance, July 2018.

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