August 10, 2023

Dear Members of the Senate Finance Committee,

Thank you for your efforts in examining how the Internal Revenue Code can be modified to more appropriately address the taxation of digital assets. I believe digital assets, specifically Bitcoin, represent technological innovation that ranks among the greatest achievements in human history. The advent of a decentralized, liquid monetary network characterized by absolute scarcity is truly an economic discovery.

As an introduction of myself, I am a CPA and Tax Partner at a top-30 national public accounting firm. Currently, I lead a specialized blockchain and digital assets practice at the firm and am deeply familiar with many of the topics presented in your letter. However, because the firm must remain independent from a policy perspective, please note that the opinions expressed within this letter are my own and do not necessarily reflect positions held by the firm.

I am highly involved in community and industry organizations, serving as Treasurer and Board Member at the North Dallas Chamber of Commerce, Board Member at the Texas Blockchain Council, Treasurer at the Bitcoin Mining Foundation, and a member of the Innovation Task Force at the Dallas Regional Chamber. I regularly present on accounting and tax issues related to digital assets, including TXCPA continuing education seminars, the North American Blockchain Summit, and the Bitcoin 2023 conference.

In the following discussion, I address the selected issues in which I have experienced in practice, researched, and formed my own opinion. I am also available to discuss these issues as needed. Please reach me by email at tim.savage@weaver.com or by phone at 972-448-9244.

Sincerely,

Tim Savage, CPA

Digital assets are characterized by features that facilitate the exchange of value at a peer-to-peer level without the need for an intermediary. While protocols and application development are still progressing to realize viable, scalable solutions, it has become clear that certain digital assets are categorically different than others. For example, Bitcoin has reached a sufficient level of global decentralization through mining activity and node accountability, which protect its defining characteristic of absolute scarcity. On the other hand, Ethereum does not offer the same scarcity model of Bitcoin, yet it offers computing and application development features that are different than Bitcoin. With different features, Ether has realized a commonly adopted use case, as it is used as a resource to power smart contracts and the applications that run on the Ethereum network. Both Bitcoin and Ether are characterized by commodity-like features, but both have different use cases. Similarly, other digital assets may have also reached sufficient levels of decentralization and adoption. For purposes of this discussion, I will not comment on the methods of identification for how decentralization and use cases are defined. Rather, the use of this theoretical definition will suffice for this discussion's purposes.

It is appropriate to point out that in the earlier life cycles of certain digital assets, the way these assets came into fruition may have been in the form of an investment contract, and it may have been appropriate to classify them as securities at the time. However, in the examples of Bitcoin and Ethereum, these networks have scaled to a sufficient level of adoption where it is no longer appropriate to classify them as securities.

As another form of digital asset, stablecoins continue to proliferate and certain stablecoin issuers are significant holders of U.S. notes and treasuries. If regulated effectively, it is appropriate to classify stablecoins as either currency itself, if pegged value can be sufficiently maintained, or to classify them as a currency derivative.

Other digital assets are born out of investment contract models, have not reached sufficient levels of decentralization, and do not have commonly adopted use cases. It is therefore appropriate to classify these types of digital assets as securities. However, issuance of such digital assets after the initial investment offering may not give rise to meeting the criteria for securities classification. Therefore, it is appropriate to respect the classifications and determinations of enacted legislation, court rulings, and regulatory authority.

Based on these considerations, it is appropriate to classify Bitcoin, Ether, and perhaps other digital assets with sufficient levels of decentralization and adoption as commodities due to their commodity-like properties, and many other digital assets should be classified as securities until they reach sufficient levels of decentralization and adoption. Nonfungible assets should be classified as digital products, collectible items, or in certain instances as securities depending on how the assets are produced. In the future, it may be appropriate to classify other forms of tokenized assets as securities, though in some instances it may be more appropriate to treat such tokens according to the underlying asset depending on the use case.

The most effective way to address digital assets in the Internal Revenue Code is to first establish statutory definitions for various types of digital assets. These definitions set the framework for addressing each tax issue, serving as the basis for further iteration. As an illustration, the Internal Revenue Code can be modified to address digital assets with the following definitions:

§475(h) Definition of Digital Assets

>*(1) In General*
>*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 ledger or any similar technology as specified by the Secretary.*

>*(2) Digital Commodity*
>*The term "digital commodity" means any digital asset described in paragraph (1) and functions as a commodity as described in section (e)(2).*

>*(3) Digital Security*
>*The term "digital security" means any digital asset described in paragraph (1) and functions as a security as described in section (c)(2).*

>*(4) Digital Token*
>*The term "digital token" means any digital asset described in paragraph (1) and functions not as a digital commodity described in paragraph (2) or digital security described in paragraph (3).*

>*(5) Digital Asset Exchange*
>*The term "digital asset exchange" means any organization or technology, as specified by the Secretary, providing digital asset services that contract to trade digital assets as described in paragraph (1).*

The addition of these statutory definitions in the Internal Revenue Code are specific enough to encompass digital assets and exchanges in current form, yet they are broad enough for future innovations. These definitions can be referenced in other areas of the tax code, and applicable code sections among the selected issues for discussion can be modified accordingly.

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

• **Should traders of digital assets be permitted to mark to market? Why?**

A fundamental premise of digital assets is that they are highly liquid and can be exchanged with relative ease. Application user interfacing continues to improve, making these assets friendlier for public use and wider adoption. Increased adoption consequently broadens digital asset markets. Additionally, technological advances in blockchain indexes and block explorer applications accurately corroborate market values similar to existing stock market indexes, enabling reliable information to be drawn from market data.

The markets for digital assets are mature and accessible enough to support the case for mark to market treatment. Traders should be permitted to elect mark to market if they are trading digital assets that are (1) brokered through regulated digital asset exchanges and (2) the assets have readily ascertainable market values.

• **Should dealers of digital assets be permitted or required to mark to market? Why?**

Conceptually, a dealer of digital assets is similar to a dealer in traditional securities and should therefore be required to mark to market. Additionally, irrespective of whether certain digital assets are classified as securities or commodities, the fundamental premise of digital assets and the maturity of broad, liquid markets supports the fact that all dealers of digital assets should be required to mark to market.

• **Should the answer depend on the type of digital asset? How should digital assets be determined to be actively traded (under IRC Section 475(e)(2)(A))?**

§475 should be modified to specifically call for mark to market treatment for dealers of digital assets, superseding the need to further define active trading status of commodities under §475(e)(2)(A). Instead, §475(e)(2)(A) can be modified to list an exemption for digital assets under proposed §475(h)(1).

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

• **When should the policies behind the trading safe harbor (of encouraging foreign investment in U.S. investment assets) apply to digital assets? If those policies should apply to (at least some) digital assets, should digital assets fall under IRC Section 864(b)(2)(A) (trading safe harbor for securities), IRC Section 864(b)(2)(B) (trading safe harbor for commodities), or should the answer depend on the regulatory status of the specific digital asset? Why?**

The trading safe harbor should apply to a foreign person trading digital assets when trading activity rises to the level of a trade or business. For qualification purposes, it is most

practical for the safe harbor criteria to (1) make the determination of qualifying digital assets based on regulatory status and (2) allow safe harbor treatment only if the traded digital assets are listed on a regulated digital asset exchange in the U.S. These criteria keep succinct the Internal Revenue Code with regulatory status and clearly define how the safe harbor applies to foreign traders. §864(b)(2) should be modified to expand §864(b)(2)(C) or §864(b)(2)(D) should be added to specifically list digital assets and qualifying criteria.

- **Another possibility is that a new, separate trading safe harbor could apply to digital assets. In that case, should the additional limitation on commodities eligible for the trading safe harbor apply? Why?**

While certain digital assets do have commodity-like features, it is less practical to extend the commodities limitation to digital assets because digital asset exchanges have already been established to facilitate trade. The limitation on commodities should not apply and instead the safe harbor should reference digital assets that are listed on a regulated digital asset exchange.

- **To the extent that the additional limitation on commodities for the trading safe harbor applies, how should the terms "an organized commodity exchange" and "transactions of a kind customarily consummated" (in IRC Section 864(b)(2)(B)(iii)) be interpreted in the context of different kinds of digital asset exchanges?**

I maintain that the limitation on commodities should not apply. However, if it is deemed to apply, §864(b)(2)(B)(iii) should be modified as, *"Clauses (i) and (ii) shall apply only if the commodities are of a kind customarily dealt in on an organized commodity exchange, digital assets as defined under §475(h)(2) that are traded in a digital asset exchange as defined under proposed §475(h)(5), and if the transaction is of a kind customarily consummated at such place."* This modification clarifies the distinction between digital assets classified as commodities and the expansion of the limitation.

Wash Sales (IRC Section 1091)

- **In what situations do taxpayers take the position that economic substance (IRC Section 7701(o)) applies to wash sales with regards to digital assets?**

In certain instances, a taxpayer may harvest capital losses from digital assets with a subjective non-tax purpose. However, it is difficult to argue the economic substance doctrine applies to losses generated during regular trading activity. One example where the doctrine could apply is with the failures of Terra Luna and FTX token, when holders of these tokens sought to liquidate their positions into other digital assets as the tokens experienced a terminal collapse in market value. A second example where the doctrine could apply is as a result of a network hard fork, as token holders of the less adopted network may seek to liquidate their positions into the more successful network chain.

- **Are there existing best practices for reporting transactions in digital assets that are economically equivalent to wash sales?**

  Currently, there are no existing best or common practices for reporting transactions in digital assets that are economically equivalent to wash sales. There is little guidance as to whether wash sales should apply, and without guidance there is no standardization of procedures in reporting these transactions.

- **Should IRC Section 1091 apply to digital assets? Why or why not?**

  While digital asset use cases continue to mature, the majority of interactions with digital assets are currently executed with the intent of trading for profit. Traders frequently exchange one type of digital asset for another as price action fluctuates, and they are generally less concerned whether a digital asset is considered a digital commodity versus digital security. Traders also typically prefer to convert back to certain digital assets such as Bitcoin, Ether, or stablecoins as profits are realized. Thus, it is difficult to argue that such trades satisfy the economic substance doctrine and the general wash sale rules should apply to digital asset trades.

  However, it is prudent to consider that certain digital assets might eventually become a widely accepted medium of exchange. In some scenarios, an individual may wish to convert certain digital assets for short-term utility purposes and subsequently convert back to the original when the utility is no longer necessary. It may be helpful to modify the wash sale rules to provide an exemption for a low frequency trade threshold to accommodate individuals in such scenarios.

- **Should IRC Section 1091 apply to other assets beyond digital assets? If so, what assets and why or why not?**

  Wash sales should not apply beyond current application to stock, securities, and digital assets. Conceptually, these types of assets have highly liquid, accessible markets with regulated market makers. It is appropriate for wash sales to apply to these assets because they offer the highest potential for trading frequency. Markets for other assets are less accessible, require more effort to effectuate trades, or such other assets are properly addressed in other areas of the tax code.

Constructive Sales (IRC Section 1259)

- **In what situations do taxpayers take the position that economic substance (IRC Section 7701(o)) applies to constructive sales with regards to digital assets?**

  Given that digital assets are considered property and the constructive sales rules were meant to deter taxpayers with appreciated financial positions from bypassing short term

capital gains rates by generating investment gains without incurring realized capital gains, it is difficult to argue that the constructive sale rules should not apply. In practice, direct short sales of digital assets are not common. However, digital asset futures and perpetual contracts are becoming more widely used. Taxpayers who engage in digital asset short sales against the box can utilize futures and perpetual contracts as a hedging strategy to reduce loss exposure while maintaining long positions.

- **Are there existing best practices for reporting transactions in digital assets that are economically equivalent to constructive sales?**

  Currently, there are no existing best or common practices for reporting transactions in digital assets that are economically equivalent to constructive sales. There is little guidance as to whether constructive sales should apply, and without guidance there is no standardization of procedures in reporting these transactions.

- **Should IRC Section 1259 apply to digital assets? Why?**

  Along the same line of reasoning concerning whether wash sale rules should apply to digital assets, it is appropriate for the constructive sale rules to also apply to digital assets. Additionally, digital asset derivative contracts continue to gain traction, expanding the complexity of how taxpayers can interact with digital assets.

- **Should IRC Section 1259 apply to other assets beyond digital assets? If so, what assets and why?**

  Similar to the above response in the wash sales section, constructive sales should not apply beyond current application to stock, securities, and digital assets.

Timing and Source of Income Earned from Staking and Mining

- **Please describe the various types of rewards provided for mining and staking.**

  Proof-of-work (POW) mining rewards consist of two components – (1) transaction fees that miners collect for minting new blocks on the network chain, and (2) preset subsidies that are attached to each block that is mined according to a specified issuance schedule maintained by the network's algorithm.

  Proof-of-stake (POS) rewards generally consist of one or two components - (1) transaction fees that validators collect for minting new blocks on the network chain, and/or (2) algorithmically programmed rewards based on a validator's participation in a staking pool.

- **How should returns and rewards received for validating (mining, staking, etc) be treated for tax purposes? Why? Should different validation mechanisms be treated differently? Why?**

  POW mining and POS validation should be treated as separate and distinct activities for tax purposes. The technical processes of how taxpayers participate in these activities are different, and each protocol offers different financial incentive mechanisms.

  The process of participating in POW mining involves a much higher level of commitment than POS validation. First, a miner must identify an adequate energy source to power operations. Second, a miner must deploy specialized computing equipment and software applications to participate in the network's algorithm. Third, a miner must maintain and upgrade the equipment and software as its assets depreciate.

  While a single miner can participate in the network, POW mining markets are quickly evolving into a unique commercial industry. Businesses both small and large have been born to participate in POW mining. At the commercial level, the time and effort required to deploy such an operation is significant. Commercial miners operate as large scale businesses, negotiate contracts, hire employees, and manage complex financial systems.

  As of today, the Bitcoin network is by far the largest and primary form of POW mining. Due to the network's fixed supply, preset block reward subsidies, and algorithmic issuance schedule, the mathematical determinations of remaining supply can be calculated with relative ease. It is expected that the last block subsidy will be mined by approximately 2140. The network's unique model of digital scarcity, powered and secured by the conversion of energy into the network, results in a depletable, commodity-like resource pool.

  Conceptually, mining activity is similar to upstream oil and gas exploration activity. Both activities incur a substantial amount of capital and operational expenditure to identify resource locations and deploy equipment, both engage in contracts to obtain resources, and both draw resources from a limited, depletable resource pool.

  Under current tax guidance, a major difference between these two types of activities is that an oil and gas exploration company can maintain inventory reserves on balance sheet and may sell assets at a later time without recognizing taxable income at the time of production. Conversely, under the current guidance of Notice 2014-21, mining companies must recognize rewards as taxable income upon receipt. When assets held in inventory reserves are subsequently sold, the disposition then triggers a second taxable event.

  Based on the conceptual similarities between these two types of activities, it is most appropriate for POW mining rewards to be considered inventory for tax purposes with no taxable income recognition until future disposition. Accordingly, §263A should be modified to specifically apply the uniform capitalization rules to digital commodity businesses.

Participating in a POS validation is a much simpler process. Generally, a validator deploys a POS network's software application and places the digital assets into a staking pool for a specified period of time. The network's algorithm randomly selects participants for validation and distributes validation rewards accordingly. As such, the barrier to entry for staking participation is much lower than POW mining, necessitating capital only in order to participate in the process.

While POS rewards are generally selected at random, the return on investment can be determined with reasonable accuracy. Conceptually, staking activity closely resembles an interest-bearing lending arrangement, where a lender provides capital to a borrower for a specified amount of time and receives interest income in return. Based on the conceptual similarities between these two types of activities, it is most appropriate for POS rewards to be taxed as ordinary income upon receipt.

- **Should the character and timing of income from mining and staking be the same? Why or why not?**

  Both POW and POS income should be treated as ordinary income. However, there should be differences in timing between these two types of activities. As described above, POW rewards should be allocated to inventory under §263A and taxed as ordinary income upon future disposition. POS rewards should be taxed as ordinary income upon receipt.

- **What factors should be most important when determining when an individual is participating in mining in the trade or business of mining?**

  Individuals who participate in POW mining should evaluate whether mining activity gives rise to the level of a trade or business or whether the activity should fall under the §183 hobby loss rules.

- **What factors should be most important when determining when an individual is participating in staking in the trade or business of staking?**

  Individuals who participate in POS validation should evaluate whether staking activity gives rise to the level of a trade or business or whether the activity should fall under the §183 hobby loss rules.

- **Please describe examples of the arrangements for those participating in staking pool protocols.**

  There are various consensus protocols for staking arrangements. The example and analogy described above is the general arrangement that encompasses the necessary considerations for tax purposes.

- **Please describe the appropriate treatment for the various types of income and rewards individuals staking for others or in a pool receive.**

  An individual that transfers digital assets to another entity to engage in a staking activity is generally engaging in a lending/borrowing arrangement. The entity that is engaging in the staking activity enters into a subsequent lending arrangement with the network protocol, as described above. In both instances, income should be treated as ordinary income and taxable upon receipt.

- **What is the proper source of staking rewards? Why?**

  This is difficult to determine with reasonable accuracy, as most staking protocols circulate network fees among network users and staking participants. In some protocols, network incentives are drawn from a network's treasury reserves, which allows for compatibility in sourcing the rewards. However, the nature of staking does not change the profit motive by which participants engage in the network. Thus, irrespective of whether the source of staking rewards can be identified, it is more appropriate to classify staking rewards as ordinary income upon receipt.

- **Please provide feedback on the Biden Administration's proposal to impose an excise tax on mining.**

  The proposal to impose an excise tax on POW mining should not be enacted. I implore the Administration to engage academic institutions to perform independent research on the industry, weighing the advantages and disadvantages before enacting a law that will drive mining away from the nation.

  Rather than pushing out a nascent industry with tremendous potential, it is prudent to examine how POW mining can be used to benefit the economy. For example, Bitcoin mines offer flexible demand on energy load, as they can be turned on and off almost instantly without damaging the equipment. They are also location agnostic, as they can easily be transported from one location to another.

  Independent reports suggest that up to 68% of electricity generated in the U.S. is wasted. To reduce energy waste, it is sensible to explore how that energy could be monetized with a flexible demand on energy load. Additionally, the expansion of clean energy and renewables is an expensive endeavor. Wind and solar farms can produce large energy loads, but on many days excess production is wasted due to difficulties with electricity storage and transportation. Instead of imposing a broad excise tax POW mining electricity costs, it would be more beneficial to incentivize Bitcoin mines to be deployed at qualified renewable sites that systemically overproduce. The mining rewards generated from these sites can be taxed and funding can be used to subsidize rising energy costs in more densely populated areas.

Nonfunctional Currency (IRC Section 988(e))

- **Should a *de minimis* nonrecognition rule like the rule in IRC Section 988(e) apply to digital assets? Why? What threshold is appropriate and why?**

  Certain digital assets are characterized by monetary properties, though currently they are not commonly used as mediums of exchange or currency. However, it is important to note that two sovereign nations have declared Bitcoin as legal tender, and a number of other nations have enacted favorable policies. In the future, it is conceivable that additional sovereign nations may adopt decentralized digital assets as legal tender or will enact favorable policies. If this scenario comes to fruition, it would be logical to adopt an inflation adjusted de minimis threshold to reduce the burden of tax reporting for digital assets that are used as mediums of exchange.

- **Are there existing best practices that would prevent taxpayers from avoiding tax obligations if a nonrecognition rule were to apply? What reporting regime would help taxpayers comply?**

  Currently, taxpayers who interact with digital assets are required by law to maintain adequate transaction records, but it is difficult to track high frequencies of transactions. Increasingly, taxpayers are utilizing specialized digital asset software solutions to assist with basis and tax calculations. These software products are not always completely accurate, but they are helpful at minimum.

  It is infeasible to subject digital asset service providers to a reporting regime, as the burden of producing such information is impractical, certain information may not be available to the service providers, and how such information would be utilized at the taxpayer level may not achieve the intended result. Instead, it should continue to be the taxpayer's responsibility to maintain adequate transaction records, and it should be the taxpayer's responsibility to identify assets and transactions for nonrecognition purposes.

FATCA and FBAR Reporting (IRC Sections 6038D, 1471-1474, 6050I, & 31 U.S.C. Section 5311)

- **When do taxpayers report digital assets or digital asset transactions on FATCA forms (e.g. Form 8938), FBAR FinCEN Form 114, and/or Form 8300? If taxpayers report some categories and not others, please explain and identify which categories of digital assets are reported and not reported with respect to each of these forms. Should FATCA, FBAR, and/or 8300 reporting requirements be clarified to eliminate ambiguity about whether they apply to all, and/or some categories of, digital assets? Why?**

  Digital assets are not currently listed as reportable on FATCA or FinCEN forms. Given the nature of digital assets and similarities between other reportable assets, the reporting requirements should be modified to include digital assets.

- **Given the policies behind FBAR and FATCA, should digital assets be more integrated into those reporting regimes? Are there barriers to doing so? What are they?**

  Digital assets should be more integrated into these reporting regimes. The burden of producing such information would be no greater than if the assets were held domestically.

Valuation and Substantiation (IRC Section 170)

- **Digital assets do not currently qualify for the IRC Section 170(f)(11) exception for assets that have a readily available valuation on an exchange. Should the substantiation rules be modified to account for digital assets? If so, in what ways and for which types of digital assets? More specifically, would something different need to be done for those publicly traded digital assets?**

  As discussed earlier, technological advances in blockchain indexes and block explorer applications accurately corroborate market values similar to existing stock indexes, enabling reliable information to be drawn from market data. Additionally, blockchain networks are inherently traceable, allowing for historical pricing to be maintained reliably for public use. Digital asset values produced from a regulated digital asset exchange, as defined under proposed §475(h)(5), should qualify under the substantiation rules.

  For charitable contribution purposes, the appraisal requirements as specified by §170(f)(11)(C), should list a specific exemption for digital assets that are traded on a regulated digital asset exchange. As applicable, taxpayers should continue to produce Form 8283 with income tax returns with a Part IV declaration.

- **What are the characteristics of an exchange and the digital asset for which this exemption would appropriately apply and why?**

  As discussed earlier, a digital asset that is listed on a digital asset exchange meeting the definition under proposed §475(h)(5) should qualify for the exemption.