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In Brief: Analysis of Three Digital Asset Tax Proposals[1]

The Responsible Financial Innovation Act (RFIA), introduced by Senators Lummis and Gillibrand, proposes to give digital assets special tax advantages over most other types of property. Income tax law ordinarily treats income as taxable when received, but the RFIA would exempt much income from digital assets from this general approach, and instead tax it later, or, in some cases, not at all. This amounts to a tax subsidy for digital assets. The RFIA would also weaken the authority of Treasury and the Internal Revenue Service (IRS) to establish information reporting rules, undermining attempts to ensure that income taxes owed are paid on income flowing from digital assets. We analyze three major tax provisions of the RFIA:[2]

First, the RFIA would allow digital asset validators to defer income from *mining* and *staking*, two methods of validating transactions on the blockchain in exchange for digital asset rewards.

- This would give income from mining and staking more favorable tax treatment than income from work, or income generated from other assets. Essentially, the proposal would provide a tax subsidy for mining and staking, which may encourage financial resources, computing power, and energy to flow to these activities rather than other industries and uses.
- It would also encourage "lock-in" (taxpayers holding onto digital assets for longer periods due to tax benefits than they would otherwise).
- The proposal also creates tax traps for the unwary, who are likely to be those with smaller holdings of digital assets, while delivering the bulk of the tax benefits to those who hold the largest amounts of digital assets and are likely to be most sophisticated.

Second, the bill would exclude from gross income up to $200 of gain or loss per personal transaction when individuals pay for goods or services using virtual currency.

- This exclusion would also be a tax preference for virtual currency, and effectively subsidize it relative to other assets or cash. Individuals would be able to realize income by paying for

[1] This document is a summary of the report "Taxing Digital Assets: What's at Stake?" by Michael Kaercher and Taylor Cranor.

[2] We do not discuss the other tax provisions in the RFIA. Section 203 of RFIA "[e]xtends the current safe harbors for securities and commodities trading activity made by non-United States persons who use a United States financial institution to conduct digital asset trading activities under specified conditions, including that the non-United States person does not have an office in the United States." *Lummis-Gillibrand Responsible Financial Innovation Act Section-by-Section Overview* 1 (2022). Section 204 "[s]pecifies that certain decentralized autonomous organizations (DAOs) are business entities for the purposes of the tax code." *Id.* Section 205 "[e]stablishes that digital asset lending agreements are not generally taxable events, in the same way that securities lending transactions are not today" under section 1058. *Id.* Section 206 mandates that the IRS publish guidance on a number of tax questions related to digital assets. *Id.* Section 207 requires the Comptroller General to write a report on retirement investing in digital assets. *Id.*

goods and services with appreciated virtual currency, but would not be taxed on any gain up to $200.

- Some argue that such an exclusion is necessary because virtual currency is like foreign currency, which already has a *de minimis* gain exclusion under section 988(e).[3] This argument ignores important differences between virtual currency and foreign currency.
- The exclusion would also create administrative and enforcement burdens.

Third, the RFIA would modify the broker reporting regime, narrowing who qualifies as a "broker" under section 6045 and what information can be shared under section 6045A.

- Broker reporting helps the IRS confirm that taxpayers are accurately reporting their gain (or loss), and in so doing encourages voluntary compliance with tax laws by those dealing in digital assets. It also plays an important role in ensuring individuals have the information they need to include the gain (or loss) they realize on the sale or disposition of appreciated (or depreciated) assets on their tax returns.
- Broker reporting under section 6045 already applies to brokers of many other types of assets, and a provision of the Infrastructure Investment and Jobs Act confirmed that this reporting also applies to digital assets. However, the RFIA's changes would narrow Treasury's authority to create a broker reporting regime that covers as many relevant transactions as possible while minimizing burden.
- As a result, the RFIA would likely hinder the broker reporting regime's aim of ensuring taxpayers with digital assets include all their realized income on their tax return.

Considering costs to the tax system when assessing tax subsidies for digital assets

Tax subsidies for digital assets like those proposed in the RFIA would come at a federal budget cost and lawmakers should consider and explain whether such subsidies are justified. This requires assessing the potential social costs and benefits of encouraging resources to flow towards digital assets and away from other investments and activities.

There is extensive debate about these costs and benefits,[4] and we do not evaluate them all. However, in undertaking this evaluation, lawmakers should consider that administering these tax subsidies and encouraging the use of digital assets more broadly would likely have significant negative impacts on the tax system and tax compliance, given the role of digital assets in facilitating tax evasion and other illicit activity more broadly.[5]

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[3] All references to "section" are to sections of the Internal Revenue Code of 1986, as amended.

[4] For an example of an overview, *see* David Perkins, Cong. Rsch. Serv., R45427, *Cryptocurrency: The Economics of Money and Selected Policy Issues* (2020).

[5] *See, e.g.,* US Dep't of Just., *How To Strengthen International Law Enforcement Cooperation For Detecting, Investigating, And Prosecuting Criminal Activity Related To Digital Assets* 21-24 (2022).