Litigation and Taxation Implications For Cryptocurrencies

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Crypto is no longer just in the radar of techno-anarchists. Satoshi Nakamoto may have intended for Bitcoin to replace banks and make regulators obsolete, but a lack of any governance in nations doesn't end well in terms of empowering all citizen and individuals. As of 2023, courts around the world have begun to take interest in litigating this technology. The amount of fraud and mishandling of investments from crypto-companies is staggering, as many people view blockchain-based assets as investments, but there is a clear lack of regulatory clarity surrounding business operations in this space. Ryskamp (2020) describes the three areas cryptocurrency litigation focuses on: Initial Coin Offerings (ICOs), crypto-exchanges, and smart contracts. This paper briefly discusses litigation efforts around the world as well as the implications of blockchain on tax law. This paper looks into peer-reviewed literature as well as online articles to shed light on these topics.

A Brief Summary of Major Litigation Efforts in the United States

Blockchain technology was touted as an environment where "code is law" by Satoshi Nakamoto. The problem right now is that blockchain technology is complicated enough that courts around the world are struggling to properly litigate fraudulent activity among business professionals in the blockchain space. Ryskamp provides some examples of private companies in each of the three categories mentioned earlier. Firstly, ICOs from a number of companies have been fraudulent. Tezos took money from people during their ICO and recorded the transactions are non-refundable donations as well as not informing investors that the product was actually years away from actually being ready. Since the $232 million pool was made up of people expecting the money to be an investment, Tezos was in the wrong and hit with heavy fines while also tanking their reputation. Tezos isn't the first company to run a fraudulent ICOs and it certainly won't be the last. Ryskamp also provides Kraken as an example for a company that was unable to protect investor assets within their crypto-exchange. Kraken failed to shut down trading during a DDoS attack, which lead to the loss of 3,414.08669 Ether. Another famous exchange going through the litigation process in late-2023 is Futures Exchange (FTX), where the founder Sam Bankman Fried (FTX) committed embezzlement (Knauth, 2023). This ongoing case is still trying to assess the damages FTX had on the the crypto-market, as these exchanges hold so much crypto have a significant impact on crypto-market valuations. The result of these litigation efforts could require exchanges to properly verify their reserves. Finally, smart contracts provide a level of complexity that makes litigation challenging. TheDAO, the first decentralized autonomous organization, was published to the Ethereum blockchain in 2016. Unfortunately, the fund within TheDAO's wallet lost a significant amount of funds because a hacker exploited a recursive function in the code. In the future, developers could be held liable for a lack of due diligence, since smart contracts require Finite State Machine design patterns (Mavridou & Laszka, 2017).

Article Review on Distributed Public Ledgers and Blockchain Litigation

Webster & Charfoos (2018) do a full analysis of blockchain lawsuits filed around the world. The distributed and public nature of blockchains makes it difficult to pinpoint a single entity at fault, since design principles such as distributed organization and public ledgers add unique elements for enforcement. Webster & Charfoos concluded that much of blockchain is a nascent technology beginning to go mainstream. Aside from companies like Tezos, Kraken, FTX, and TheDAO, there are numerous court cases littered with allegations of unreliable partners, financial loss, and parties trying to get onto a hot trend without understanding the risks. Two additional litigation topics presented by Webster & Charfoos within global markets include use of cryptocurrency to pay for criminal enterprises as well as employment-related disputes regarding intellectual property.

The IRS on Taxation of Cryptocurrency

America is a rather litigious nation and the number of court cases in the United States revolving blockchain has caused regulatory bodies the begin acting. The IRS has already begun to take interest in taxing crypto investments. Brooks (2023) provides a basic guide on how US tax laws apply to cryptocurrency trades. Unbeknownst to many investors, major exchanges such as Coinbase are required to fill out 1099 forms to the IRS, which contains personal information. The 2021 Infrastructure Bill requires strict reporting from all American exchange, which gives the IRS information to identify tax cheats once the bill goes into effect.

Essentially, ordinary income taxes as well as capital gains taxes apply to cryptocurrencies as well - just convert the cryptocurrency valuation to US dollars. Much like trades done in US dollars, you incur a taxable event on capital gains whenever you dispose of your cryptocurrency - i.e. selling the crypto, exchanging the crypto for another crypto, as well as using the crypto to make a purchase. Moving on, income taxes on cryptocurrency is owed whenever profits are made from mining rewards, airdrop rewards, or staking rewards. It is possible that depending on the consensus mechanism, miners/validators of various type will also be subject to taxes on profits earned. It’s also important to note, taxes will not be incurred for events like holding cryptocurrency, transferring your crypto from one wallet you own to another wallet you own, as well as using crypto as collateral for a loan. The IRS can in fact trace transactions on the blockchain, since they work with contractors like Chainalysis to trace all transactions.

Peer Reviewed Literature on Impact of Blockchain Technology on Tax Law and the Tax Administration Within Russia

Moving a little way from the IRS, Lyutova & Fialkovskaya (2021) explore a much more radical and in-depth look into how blockchain can fundamentally transform concepts relating to taxation. In their vision, blockchains can be used to create a system of automatic taxation, where "smart taxes" automatically crunch numbers for the system. In the context of tax law, blockchain technology can be used to reduce the costs of document flow. Blockchain-based tax systems can essentially reduce the expenses of tax reporting while also establishing and executing tax obligations automatically. Lyutova & Fialkovskaya assert that blockchain has the potential to transition the tax administration from an imperious relationship to one based on constructive cooperation between public and private sectors. They also assert the innovation in blockchain is "the service of the state," which may differ from the Unites States's view on the matter. Another useful feature of blockchain, traceability, can also help calculate the balances of goods in a particular taxpayer's warehouse, further improving reporting and automation.

Pros and Cons of Blockchain Litigation and Taxation

Unfortunately, the rapid rise of fraud among blockchain companies in the private sector of the United States has forced courts to be involved. The courts acknowledge that investors need to have protections in place, but there is still a lack of regulatory clarity on how markets should proceed in terms of fully tapping into this space. The IRS has stepped up to try and tax cryptocurrency, but nothing has yet come into effect. It is too early to determine whether taxation from the IRS will lower trading volume by itself or not. "Smart taxes," however, could potentially transform the nature of the tax system itself. If one thing is for sure, blockchain-based systems must uphold principles of safety, protection of personal information, decentralization, availability, transparency, and consensus. Without these principles, a fully digital tax system could be more dystopian than empowering.

Conclusion

The sheer number of litigations involving cryptocurrency and blockchain is overwhelming. As a result, regulatory bodies around the world are looking to see what is going on within this space as well as attempt at regulations to protect investors and spur innovation. In tax law, blockchains have not yet developed as a distinctive phenomenon. The IRS has specifically focused on the problem of establishing tax consequences of activities that make use of cryptocurrencies while also acknowledging that blockchain is the technological basis for its functions (as in, let's charge a tax on the miners/validators too). The Russian federation, however, is exploring how blockchain technology can fundamentally change the taxation system.

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