



September 4, 2020

## CRYPTOCURRENCIES GARNER ATTENTION FROM FEDERAL AGENCIES

State and federal regulators continue to wrestle with digital currency issues. Notable developments at the federal level include the following:

### OCC ANPRM and Letter Regarding Cryptoassets

On July 7<sup>th</sup>, the Office of the Comptroller of the Currency (“OCC”) issued an advance notice of proposed rulemaking and requested comments by August 3<sup>rd</sup> related to its regulations on banking issues related to digital activities, use of technology and innovation. The notice posed a number of questions for the public to answer, including the following set of questions related to cryptocurrency:

- (1) What types of activities related to cryptocurrencies or cryptoassets are financial services companies or bank customers engaged?
- (2) To what extent does customer engagement in crypto-related activities impact banks and the banking industry?
- (3) What are the barriers or obstacles, if any, to further adoption of crypto-related activities in the banking industry?
- (4) Are there specific activities that should be addressed in regulatory guidance, including regulations?

The notice received over 90 comments, including comments from a few national banks. One national bank’s chief digital officer commented that the OCC and other banking regulators should issue guidance around the cryptocurrency market as well as the expectations for services conducted on distributed ledger technology, as the lack of clear regulations might result in both banks and customers being unwilling to invest or use cryptocurrencies and similar digital assets.

On July 22, the OCC released Interpretive Letter #1170 that states that a national bank may provide cryptocurrency custody services on behalf of customers, including holding the unique cryptographic keys associated with cryptocurrencies. The Interpretive Letter states that providing cryptocurrency custody services is a modern form of traditional banking activities, including providing safekeeping and custody services of customer assets. The Interpretive Letter states that the OCC recognizes that, as financial

markets become increasingly technological, there will likely be increasing need for banks and other service providers to leverage new technology and innovative ways to provide traditional services on behalf of customers.

The OCC is also expected to report further this Fall on a proposed special purpose national bank charter for payment companies and cryptocurrency exchanges. The anticipated charter would allow the payment companies and cryptocurrency exchanges to operate across state lines under a single set of rules as well as to expand the financial services they offer. The new charter is expected to be issued in two phases: First, a “Payments Charter 1.0” would be offered as, essentially, national money-transmitter license. Then, about 18 months later, a “Payments Charter 2.0” would become available that would include the ability to clear payments through the Federal Reserve System directly rather than through a correspondent bank, clearinghouse or financial institution.

### FRB Digital Currency Research

On August 13, 2020, Federal Reserve Governor Lael Brainard spoke during the Federal Reserve Innovation Office Hours at the Federal Reserve Bank of San Francisco about ongoing research and experimentation related to distributed ledger technologies and the potential use cases for digital currencies.

In the speech, Governor Brainard stated that the Board of Governors of the Federal Reserve System (“FRB”) is continuing to assess the opportunities and challenges of, as well as the use cases for, a central bank digital currency (“CBDC”). Before the FRB would issue a CBDC, a significant policy process would be required to consider the issuance of a CBDC, along with extensive deliberations and engagement with other parts of the federal government. Governor Brainard stated that the FRB has not made a decision whether to undertake such a significant policy process, as it is taking the time and effort to understand the significant implications of digital currencies and CBDCs around the globe.

This effort in addition to the FRB’s continuing effort to implement its instant payment platform, FedNow, by 2023 or “as soon as practically possible”.

### IRS Virtual Currency Question

On August 18, 2020, the Internal Revenue Service (“IRS”) released a draft Form 1040 containing the following question placed directly below the taxpayer’s personal information: “If at any time

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during 2020, did a taxpayer receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?"

In 2019, the IRS introduced this same question as a cryptocurrency compliance measure, but the question was placed at the top of Schedule 1, Additional Income and Adjustments to Income. The question on Schedule 1 likely did not receive much attention as Schedule 1 is only for citizens who have income separate from the typical W-2 earnings from employment, such as business or rental income or alimony, or from unemployment compensation.

The IRS has released a list of 45 frequently asked questions on virtual currency transactions and a 2019 revised ruling discussing what cryptocurrency transactions are taxable. According to the frequently asked questions, when a person sells virtual currency, the person must recognize any capital gain or loss on the sale, subject to any limitations on the deductibility of capital losses.

The revised ruling further elaborated that a taxpayer has gross income as a result of an "airdrop" of a new cryptocurrency following a "hard fork" if the taxpayer receives units of new cryptocurrency. A "hard fork" occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a new permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. An "airdrop" is a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers. Thus, if the taxpayer holds 50 units of Crypto R and Crypto R experiences a "hard fork" resulting in Crypto S, and 25 units of Crypto S are "airdropped" to the taxpayer's distributed ledger address, the value of Crypto S is taxable gross income.

The draft Form 1040, frequently asked questions and revised ruling exemplify the importance and the emphasis the IRS is putting on cryptocurrencies. In 2019, the IRS sent more than 10,000 letters to U.S. citizens suggesting unpaid taxes on crypto transactions, based on information provided by exchanges. According to a letter shared by bitcoin tax software provider Cointrack, the IRS has sent out another wave of cryptocurrency tax warning letters in August 2020.

Federal regulatory agencies have been grappling with how to handle and regulate digital currencies for the past few years. See, e.g., our prior ALERTS of May 13, 2019 and March 28, 2018. As the interest in instant payments and the use of virtual currencies continue to evolve and increase, the use of virtual currencies would benefit from uniform regulation. If you have any questions about virtual currency regulation, please let us know.

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