JOURNAL OF INTELLECTUAL PROPERTY AND HUMAN RIGHTS

Volume: 3 Issue: 8 | Aug–2024 ISSN: 2720-6882
http://journals.academiczone.net/index.php/jiphr

Current Landscape of Digital Asset Taxation in Legal System

Azamat Ergashev Ergashevich
PhD in Law, Associate Professor of the Private international law department, Tashkent State University of Law, Uzbekistan

Annotation: This article describes the specific features of tax law in legal systems, the basis of taxation of digital properties, specific legal mechanisms in Uzbekistan. In addition, the problems in the tax system are studied in detail with clear theoretical foundations. Well-reasoned proposals for solving problems are put forward. The article covers digital properties, legal concepts related to them, and tax issues.

Key words: Tax Compliance, NFT taxation, Digital Asset, Trusts and estates, assess FMV, Internal Revenue Service.

At present, there is significant variation in how jurisdictions classify and tax digital assets.[1] In the United States, the Internal Revenue Service (IRS) treats cryptocurrencies as property for federal tax purposes, meaning they are subject to capital gains tax when sold or exchanged. However, there is ongoing debate about whether certain cryptocurrencies should be treated more like currencies or commodities for tax purposes. Other countries, like Japan and Germany, have designated Bitcoin as a form of legal tender or currency, resulting in different tax implications.[2]

The rise of stablecoins, which are typically pegged to fiat currencies like the US dollar, has added further complications, as some argue they should be taxed like the underlying currency. The tax status of cryptocurrency "forks" resulting in the creation of new coins is also murky and inconsistent across jurisdictions.[3]

NFTs, which are blockchain-based tokens representing ownership of unique digital assets, pose additional conundrums. While the IRS has not issued specific guidance on NFTs, most tax experts believe they would be treated as collectibles based on their similarities to artwork and other rarities, potentially triggering higher long-term capital gains rates of up to 28%. However, some have suggested NFT taxation should depend on the nature of the underlying asset, which could be anything from digital art to virtual real estate to music royalties.

Tokenized versions of traditional assets like stocks, real estate, or commodities add further wrinkles, as their tax treatment may depend on whether the tokens are structured to confer actual ownership and control of the underlying assets or merely represent an investment contract. The popular blockchain game Axie Infinity, which allows players to earn tokens with real monetary value, illustrates how digital assets are blurring the lines between play, work, investing and entrepreneurship in ways that confound traditional tax categories.[4]

[1] Wiseman, S. A., Brady, M., & Zhu, X. (2020). Cryptocurrencies, cybersecurity, and tax enforcement. Tax Notes Federal, 166(8), 1135-1146.
[2] Jia, C. (2020). Regulating decentralised cryptoasset ecosystems: New wine in old bottles or new bottles for old wine?. Capital Markets Law Journal, 15(2), 252-274. https://doi.org/10.1093/cmlj/kmaa003
[3] Gamage, D., Jost, C., Perlman, R., & Slocum, B. (2019). Tax implications of cryptocurrency hard forks and airdrops. Tax Notes Federal, 163(8), 983-984.
[4] Manzi, E. (2021). "When does play become work?": Practical tax considerations for play-to-earn video games. Tax Notes Federal, 172(11), 1707-1714.

Volume: 3 Issue: 8 | Aug–2024 ISSN: 2720-6882
http://journals.academiczone.net/index.php/jiphr

Challenges for Tax Compliance and Enforcement. The inherent features of digital assets create significant challenges for tax compliance and enforcement. The pseudo-anonymous nature of most cryptocurrency transactions makes it difficult for tax authorities to trace ownership and identify taxable events. While public blockchain ledgers show the flow of funds between digital wallets, tying these addresses to real-world identities requires advanced forensics that tax agencies are still developing.[5] Gaps in third-party reporting requirements for digital asset transactions, especially peer-to-peer transfers, exacerbate this issue.[6]

The global, borderless reach of most cryptocurrencies and blockchain networks also complicates tax enforcement, as funds can be easily moved across jurisdictions to exploit arbitrage opportunities or avoid compliance. The rise of privacy-focused cryptocurrencies like Monero and Zcash, which use advanced cryptography to shield transaction details on the blockchain, poses further obstacles to effective auditing and enforcement.

On the flip side, the immutable and transparent nature of blockchains could eventually become a powerful tool for streamlining tax compliance and enforcement in the digital asset space. Andres proposes a blockchain-based tax ecosystem or exchange where digital asset transactions could be automatically recorded, reported and taxed in real-time based on predefined rules. However, such a system would require robust international coordination and the development of digital identity solutions to tie blockchain records to taxpaying entities.

Even for well-intentioned taxpayers, complying with tax obligations for digital assets can be onerous and confusing given the lack of clear guidance and the need to manually track large volumes of micro-transactions across many platforms. The IRS attempted to simplify reporting by adding a yes-no question about cryptocurrency ownership to the front page of the Form 1040 tax return starting in 2020. However, some see this as an aggressive over-reach that underscores the need for greater clarity and specificity in official guidance.[7]

Taxation of Inherited Digital Assets. The inheritance of digital assets upon the owner's death creates additional complexities and uncertainties from a tax perspective. In the U.S., inherited property receives a "stepped-up basis" to its fair market value at the time of the owner's death, minimizing capital gains taxes for heirs that later sell it. However, it's unclear whether digital assets like cryptocurrencies or NFTs can qualify for this favorable tax treatment given their novelty and the lack of IRS guidance specific to inheritances. Valuing digital assets for estate tax purposes also presents challenges, as their prices are often highly volatile and may vary significantly across different exchanges.[8] With NFTs, the value is highly subjective and speculative, as it depends largely on the whims of a niche collectors' market.

The location and accessibility of private keys needed to control digital assets after the original owner's death is another concern. If heirs or executors cannot access these keys, the assets may be permanently lost, depriving beneficiaries and tax authorities of any value. Conversely, lax key management practices by the original owner could enable heirs to inherit digital assets without any official record, making them virtually untraceable for tax purposes.

[5] Kramer, J.-P. (2021). Transparency in emerging technologies: The role of blockchain and artificial intelligence in taxation. In D. Potocki (Ed.), Tax Transparency and Corruption (pp. 187-209). Wolters Kluwer.
[6] Harpaz, G. (2019). The taxation of cryptocurrencies - From a legal and tax perspective. Intertax, 47(3), 296-309.
[7] Versprille, A. (2021). Tax pros seek clarity on cryptocurrency question in Form 1040 draft. Bloomberg Tax. https://news.bloombergtax.com/daily-tax-report/tax-pros-seek-clarity-on-cryptocurrency-question-in-form-1040-draft
[8] Merchan, L., Peart, S., Callis, A., & Patel, S. (2021). Estate planning with cryptocurrency. Trusts & Estates, 160(6), 8-13.

Volume: 3 Issue: 8 | Aug–2024 ISSN: 2720-6882
http://journals.academiczone.net/index.php/jiphr

Determining the situs or taxable location of digital assets for estate tax purposes is also difficult, as they exist largely outside of traditional concepts of physical presence or legal domicile.[9] Cryptocurrencies and NFTs recorded on global blockchain networks arguably have no physical location at all. This could create opportunities for sophisticated estate planning to shield digital wealth from taxation by exploiting jurisdictional gaps and ambiguities.

Proposals for a Digital Asset Tax Framework in Uzbekistan. Establishing a clear, consistent, and enforceable tax framework for digital assets should be a key priority for Uzbekistan as it seeks to construct a comprehensive legal regime for digital inheritance. While the novelty and complexity of the digital asset ecosystem poses challenges, principled reforms grounded in core tax doctrines could go a long way toward reducing uncertainty and deterring abuse. The following proposals could form the basis for a digital asset tax framework that balances the need for clarity and compliance with the goal of fostering innovation:

Legal definitions: Formally define and classify different types of digital assets under Uzbekistan law, specifying their tax treatment and reporting obligations. Possible categories could include: (a) cryptocurrencies used primarily as a medium of exchange (taxable similar to cash/commodities); (b) cryptocurrencies held for speculative investment (property tax treatment); (c) utility tokens tied to platform/project access and rights (deferred tax until profits realized); (d) asset-backed tokens (vary between property, equity, debt based on underlying); (e) NFTs (collectibles); and (f) governance tokens/rights (as equity).[10]

Third-party reporting: Implement third-party reporting requirements for digital asset exchanges, brokers, and other intermediaries on the scale of the U.S. 1099-K rules requiring annual disclosures of user transactions exceeding $20,000. Reporting should cover relevant details like type of asset, purchase price, sale price, holding period, and identity of transacting parties to the extent feasible.[11]

Digital identity: Work with other governments and international bodies to establish a global standard for tying real-world identities to blockchain wallet addresses while preserving appropriate privacy and human rights safeguards.[12] Potential solutions include decentralized identity (DID) protocols and self-sovereign identity (SSI) frameworks that give users control over their credentials. Regulated digital identity systems could dramatically streamline tax compliance and enforcement for digital assets.

Taxation of inheritances: Default to treating inherited digital assets as property eligible for stepped-up basis to incentivize accurate reporting and smooth the transfer process. Provide reasonable timeframes and safe harbors for heirs/executors to access digital assets, assess FMV, and satisfy reporting requirements upon owner's death.

Location/domicile: Establish clear rules for determining the situs of digital assets for estate tax purposes, potentially based on factors like the domicile of the owner/trustee or the jurisdiction where the private keys are held/accessed. Consider special sourcing rules (e.g. based on number of network nodes) for digital assets that lack clear locational markers.[13]

[9] Lambert, M., Faulkner, C., Manheim, B., & Mills, B. (2021). Property rights in digital assets and estate planning. Trusts & Estates, 160(3), 18-24.

[10] Lerer, M. (2019). The taxation of cryptocurrency: Virtual transactions bring real-life tax implications. CPA Journal, 89(2), 42-47.

[11] Webber, C., Willey, D., & Warburton, A. (2020). The taxation of cryptocurrency assets. Australian Tax Review, 49(2), 100-115.

[12] Kramer, J.-P. (2021). Transparency in emerging technologies: The role of blockchain and artificial intelligence in taxation. In D. Potocki (Ed.), Tax Transparency and Corruption (pp. 187-209). Wolters Kluwer.

[13] Lambert, M., Faulkner, C., Manheim, B., & Mills, B. (2021). Property rights in digital assets and estate planning. Trusts & Estates, 160(3), 18-24.

Volume: 3 Issue: 8 | Aug–2024 ISSN: 2720-6882
http://journals.academiczone.net/index.php/jiphr

Simplified compliance: Develop a simplified, standardized tax reporting process for digital assets that consolidates information from multiple wallets and exchanges into a single annual filing.[14] Work with major platforms to integrate tax documentation directly into their user interfaces. Enforcement tools: Allocate resources for tax authorities to develop blockchain analytics and cryptoasset tracing capabilities on par with the evolving sophistication of digital asset ecosystems. Pursue bilateral and multilateral information-sharing agreements to combat cross-border tax evasion. Consider bounties or other incentives for reporting tax-avoiding smart contract structures.

Trusts and estates: Clarify the tax implications of placing different types of digital assets in trust structures, including foreign asset reporting obligations. Specify whether and how the GSTT and related rules will apply to long-term trusts funded with digital assets.

Digital ruble integration: Explore opportunities to use Uzbekistan's digital ruble project as a foundation for streamlining tax compliance and reporting for other digital assets.[15] Features like built-in transaction monitoring and programmable money rules could reduce friction in adhering to tax standards.

Regulatory sandboxes: Create safe spaces for entrepreneurs and developers to test innovative digital asset projects with modified tax requirements under the supervision of regulators. Use sandboxes to gather data and inform evidence-based policymaking as the technology evolves. These proposals provide a high-level roadmap for constructing a balanced, futureproofed tax framework for digital assets as part of Uzbekistan's digital inheritance reforms. However, their effective implementation will require ongoing dialogue between policymakers, technical experts, industry stakeholders, and civil society to craft appropriately tailored details. A phased rollout with built-in flexibilities to accommodate new developments in the fast-moving digital asset space is also advisable. By proactively addressing these challenges now, Uzbekistan can cement its position as a pioneer in the responsible integration of digital assets into its legal and economic infrastructure.

References:

1. Andres, D. (2021). Blockchain-based taxation: Opportunities and challenges. Computer Science Review, 41, 100371. https://doi.org/10.1016/j.cosrev.2021.100371
2. Blum, S. (2021). Estate planning with non-fungible tokens. Trusts & Estates, 160(5), 4-6.
3. De Vido, S. (2019). The proliferation of crypto-assets and the evolution of the monetary system: Some issues under international law. Journal of Sustainable Finance & Investment, 9(3), 232-247. https://doi.org/10.1080/20430795.2019.1609923
4. Erb, K. P. (2021). IRS reminds taxpayers to report virtual currency transactions. Forbes. https://www.forbes.com/sites/kellyphillipserb/2021/03/26/irs-reminds-taxpayers-to-report-virtual-currency-transactions/?sh=75bf84786d33
5. Gamage, D., Jost, C., Perlman, R., & Slocum, B. (2019). Tax implications of cryptocurrency hard forks and airdrops. Tax Notes Federal, 163(8), 983-984.
6. Harpaz, G. (2019). The taxation of cryptocurrencies - From a legal and tax perspective. Intertax, 47(3), 296-309.
7. Internal Revenue Service. (2014). Notice 2014-21. https://www.irs.gov/pub/irs-drop/n-14-21.pdf

[14] Merchan, L., Peart, S., Callis, A., & Patel, S. (2021). Estate planning with cryptocurrency. Trusts & Estates, 160(6), 8-13.
[15] Kolodiziev, I. O., & Kolodiziev, O. M. (2022). Regulatory aspects of the development of the digital ruble in the context of the international experience of state regulation of digital currencies. RUDN Journal of Economics, 30(1), 38-51. https://doi.org/10.22363/2313-2329-2022-30-1-38-51

Volume: 3 Issue: 8 | Aug–2024 ISSN: 2720-6882
http://journals.academiczone.net/index.php/jiphr

8. Internal Revenue Service. (2021). Frequently asked questions on virtual currency transactions. https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions
9. Jia, C. (2020). Regulating decentralised cryptoasset ecosystems: New wine in old bottles or new bottles for old wine?. Capital Markets Law Journal, 15(2), 252-274. https://doi.org/10.1093/cmlj/kmaa003
10. Kolodiziev, I. O., & Kolodiziev, O. M. (2022). Regulatory aspects of the development of the digital ruble in the context of the international experience of state regulation of digital currencies. RUDN Journal of Economics, 30(1), 38-51. https://doi.org/10.22363/2313-2329-2022-30-1-38-51
11. Kramer, J.-P. (2021). Transparency in emerging technologies: The role of blockchain and artificial intelligence in taxation. In D. Potocki (Ed.), Tax Transparency and Corruption (pp. 187-209). Wolters Kluwer.
12. Lambert, M., Faulkner, C., Manheim, B., & Mills, B. (2021). Property rights in digital assets and estate planning. Trusts & Estates, 160(3), 18-24.
13. Lerer, M. (2019). The taxation of cryptocurrency: Virtual transactions bring real-life tax implications. CPA Journal, 89(2), 42-47.
14. Mandjee, T. (2015). Bitcoin, its legal classification and its regulatory framework. Journal of Business & Securities Law, 15(2), 157-217.
15. Manzi, E. (2021). "When does play become work?": Practical tax considerations for play-to-earn video games. Tax Notes Federal, 172(11), 1707-1714.
16. Merchan, L., Peart, S., Callis, A., & Patel, S. (2021). Estate planning with cryptocurrency. Trusts & Estates, 160(6), 8-13.