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DIGITAL ASSETS AND INSTITUTIONAL MARKETS



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Introduction

Institutional investing, broadly across private and public markets, has embraced digital assets primarily where the legal, regulatory, tax, and securities frameworks are supportive. The bulk of such investments are in public securities and in private equity or venture capital funds. However, the structures available to a digital asset investor are more diverse and include many types of digital tokens. Substantial capital could potentially enter the market in token form when the frameworks are supportive and structures are well understood. Digital asset funds (traditional advisor-managed vehicles) are currently managing approximately \$25 billion, but as of June 30, 2022, the market value of assets listed on Coinbase exceeded \$1 trillion.⁽¹⁾

The perspective of Houlihan Lokey as an investment banker and advisor to a wide range of clients includes four observations:

- 1) **Digital assets are an evolution from traditional assets, not a revolution.** There are many companies in all stages whose primary business is a result of a distributed ledger, or blockchain. The technology is new, but the business is still within the existing framework. Some situations will require special risk or transaction analysis. However, as companies become governed and established as true “native digital” assets, the framework is less applicable and the situations that require special analysis become increasingly prevalent.
- 2) **Digital assets need a regulatory, legal, tax, and securities framework to become institutional grade.** Institutional investment managers, as fiduciaries and regulated entities, must operate with conventional disclosure, risk analysis, valuation, reporting, KYC, and many other defined responsibilities. The technology and operational features of the blockchain present obstacles to a manager as the assets move toward native digital.
- 3) **Digital assets promise gains from efficiency and liquidity.** Financial market participants recognize that distributed ledger technology offers two significant areas of improvement to traditional markets. The increase in efficiency of operations, settlement, dispute, clearing, KYC, and many other areas are a significant source of value. At the same time, the potential of adjustable permissioned access to private information, the migration from securitization to tokenization (with selectable risk characteristics), and increased accessibility to a large population of assets all promise an increase in available capital and expanded liquidity.
- 4) **Digital assets are not just cryptocurrencies.** While the cryptocurrency markets have been highly visible, markets of organizations implementing blockchains to solve problems and create lasting value remain nascent. Layer 2 protocols, which extend the basic security, governance, and provenance functions of a Layer 1 blockchain, are becoming a reality, but most participants agree that development remains immature for large institutional access. Tokenized assets and non-fungible tokens (NFTs) both represent unique instruments that manifest with the same token structure as a cryptocurrency, but they are not used as a payment mechanism and are likely not frequently traded.

These high-level observations are informed by our interactions across many clients and types of digital assets. It is clear that almost all dimensions of traditional finance will encounter a digital asset analogue, which must be considered in the context of valuations, transactions, risk, and reward.

(1) <https://www.coinbase.com/explore>.

Taxonomy — ‘What Is the Box?’

Digital assets are not clearly defined or standardized, but if defined as “assets whose ownership is evidenced on a blockchain, or traditional companies whose primary business activity requires a blockchain,” the market value may exceed that of \$10 trillion. Within this definition, institutional investors will find a continuum of assets that can be segregated by legal, reg, tax, and securities issues.

Framework-Based Continuum

	Traditional companies whose primary product is blockchain	Tokens	Companies who exist natively in digital space
Legal	Perfection and custody issues	TBD	UCC 12
Regulatory	Some KYC and policy issues	TBD	Proposals and consultations
Accounting and tax	Property with reporting issues	TBD	Exposure draft due 2024
Securities	Howey Test ambiguous	TBD	Staff Bulletin #121

Since the framework is not in place for companies that exist natively in the digital space, for the purpose of a regulated U.S. investment manager, the current opportunity set is a combination of public and private securities and tokens, which are transactable. Houlihan Lokey’s many practice areas serve these businesses who are organized under traditional frameworks but whose essential products and services are based on blockchains. Despite the traditional corporate structures, however, the issues presented in valuation, corporate transaction services, capital markets, restructuring, and corporate finance all require users to be facile with the issues across the full range of digital assets and their interaction with the traditional realm.

Token Types Categorized by Relevance to Institutional Framework

In its regulatory framework, Sweden has defined three types of tokens: Currency, Utility, and Investment. While these categories are broadly useful, through the lens of an institutional investor who will need to meet standards for reporting, accounting, valuations, and investment advisory, more granularity may be appropriate. We categorize tokens into groups with similar relevant characteristics in the context of providing investment banking services:

Layer 1 blockchains: Examples are Bitcoin (BTC), Ethereum (ETH), Solana (SOL), and Avalanche (AVAX). A Layer 1 blockchain is the result of an agreement by the parties on a distributed ledger, which is evidenced by a coin or token, possibly entitling the owner to other benefits and obligations. These exist, meaning their ownership can be proven (provenance) only on the blockchain, although when held in a custodial arrangement, they can be subject to the frameworks of traditional assets.

Layer 2 blockchains and protocols: Many examples include Aave (AAVE) and Uniswap (UNI). These tokens are often built on, or require connection to, a Layer 1 blockchain, from which they inherit security and provenance characteristics. Also referred to as smart contracts, these tokens embed rules in their code, which determine and automate outcomes—so when a condition or series of conditions is satisfied, the outcome is realized, without any other external record or central counterparty validation.

Stablecoins: Examples are USD Coin (USDC), Tether (USDT), and Binance USD (BUSD). These tokens act as cash equivalents in the crypto space, allowing an owner to avoid moving crypto assets to fiat currency.

DAO (decentralized autonomous organization): An example is MakerDAO (DAI and MKR), a system of smart contracts, security tokens, and governance tokens replicating traditional corporate structures, including finance firms or banks. Governance token holders vote on risk parameters of new assets to be funded by the sale of new security tokens.

Tokenized traditional assets: An example is YIELD tokens on Stellar blockchain. Tokenization is akin to securitization but lacks the regulatory and legal framework. It facilitates fractionalization where a single large asset can be partitioned into smaller components or components with differing benefits.

NFTs: Examples of tokens of a native digital asset (an asset that does not exist in a traditional realm) are Bored Ape or Elysium Land Deed. An NFT is a unique location in a digital realm that presents in many ways—as an image, sound, or even as land in a metaverse. NFTs are at the far end of the continuum between traditional and digital assets.

Specific Observations From Selected Practice Areas

Capital Markets

- **Adoption of digital assets as an institutional asset class** – Apart from blockchain technology, tokenization, and noncrypto digital asset transformation with real-world business applications, cryptocurrency investing is developing into an institutional asset class, but that process has had fits and starts. Institutional funds need to spend the required time to study the asset class to be able to deploy capital at size—they are getting there. It started with the “true believers” that were early investors in blockchain technology or crypto-specific funds, and it is spreading to regular alternative and traditional fund managers that are allocating to the asset class.
- **Maturation of service providers** – One of the gating dynamics for that institutional adoption is the availability of institutional-grade service providers in the space. Institutional LPs demand that the funds they invest in have very high-quality processes and controls, including legal and regulatory advisors, but also technical providers such as fund administration and reporting. These service providers depend on a healthy and stable ecosystem of market participants to scale up, so as crypto investing matures, the industry needs a virtuous cycle between fund managers and their vendors.
- **Rapid creative destruction** – As is evident in this paper, digital asset investing is not limited to investing in just the major coins, and it’s certainly not limited to regular long-only investing. Innovation in coins and other assets is happening at a rapid pace, and there is a high degree of activity in activities such as tokenization, lending/borrowing, and staking—and with those activities come experimentation and success/failure, causing the sector to evolve very quickly with large amounts of capital at stake.

- **Private vs. public market impacts** – Markets for private assets may be best positioned for the benefits of evolution toward a completely digital ecosystem and framework since they are currently more inefficient and opaque than public markets. Digital ledger technology will be the next step in market evolution, continuing from paper to analog and then from analog to electronic phases. Private markets (debt, equity, real estate) still have not completed the electronification to the extent that public and OTC traded markets have, with a framework that supports derivatives, securitization, and exchange-traded structured products.
- **Private capital market participant themes** – These themes include expanding the number of participants, expanding visibility of the assets and their information, and creating customizable risk structures. Tokenization, which is an extension of securitization, combined with adjustable permissioning of verified private asset data offers a path to achieving these themes. However, a full legal and regulatory framework must be in place, i.e., securitization became robust when the REMIC laws were enacted, creating REITS, CMOs, and later CMBS, CLOs, and a wide variety of ABS. Tokenization, along with a smart contract, allows private assets to function as collateral for lending, enables fractional ownership, and ultimately gives investors control over customized risk structures.

Financial Restructuring

The discipline of financial restructuring is based on a well-established set of legal, regulatory, tax, and other considerations that are potentially challenged by the technology of distributed ledgers (blockchain) and smart contracts. The recent difficulties experienced by several cryptocurrency lenders and exchanges have highlighted the concepts of custody, KYC, security perfection, and other foundational mechanisms. Emerging risks have also been exposed, such as challenges to stay or priority (i.e., when a smart contract for a loan automatically liquidates collateral in favor of the smart contract counterparty). Has it disadvantaged another creditor or altered the queue for equitable return of assets?

The blockchain itself is a wealth of visible and reliable data that supports normal restructuring assignments and the forensic analysis of a company seeking protection. However, it also obfuscates the essential ownership of the digital asset, which is converted from a traditional realm to a digital realm through intermediaries such as wallets, self-custody, and the range of on-ramps that are necessary to all participants (borrowers/lenders, buyers/sellers, capital providers/users). This boundary between the digital and traditional realms requires deep knowledge on each side, as the design of the blockchain prevents identity from passing through the boundary.

Valuation

Currently, valuation of digital assets begins with the analysis of its characteristics, i.e., if the asset is essentially traditional and can be valued with traditional methodologies, then it presents no issues. However, as the asset moves through the continuum and presents valuation issues, the literature and best practice guidelines become scarce. The American Institute of CPAs (AICPA) has published a Practice Aid, and there are working groups in other industry bodies.⁽¹⁾ However, it will require a collaborative effort to develop the required methodologies for each token type above in compliance with the required financial reporting standards.

In valuation terms, digital assets can be placed into Levels 1, 2, or 3, with a caveat that all price data should be evaluated for appropriateness before use. While many websites and exchanges publish prices after analysis, not all will result in Level 1 (directly observable) instruments. All Level 2 and 3 valuations will require a qualitative analysis of the operation of the token, particularly those with embedded protocols, auto-executing smart contracts, or algorithmic mechanisms. At the further extreme, tokens that replicate a corporate structure may require an equity-like methodology to separate the benefits, obligations, and rewards of ownership. In the case of native digital assets, NFTs, the valuation may be a result of a robust quantitative analysis of the relative characteristics that create the uniqueness of the token, in addition to any equity-like elements.

(1) <https://us.aicpa.org/content/dam/aicpa/interestareas/informationtechnology/downloadabledocuments/2104-39790-da-pda-update-web.pdf>.

M&A Tax

In 2014, the Internal Revenue Service (IRS) published a notice taking the position that digital assets, including NFTs, are “property” for the purposes of U.S. federal income tax.⁽¹⁾ As such, a majority of taxable actions involving digital assets will incur capital gains tax treatment, similar to how stocks are taxed.⁽²⁾ Digital assets are also treated as assets for tax purposes in a number of other countries (e.g., the United Kingdom, Australia, and Canada). Other countries have exempted transactions involving digital assets from taxation (e.g., Germany, Singapore, Malaysia, and Portugal).

By treating digital assets as property rather than a currency (such as the U.S. dollar or euro), the IRS requires a taxpayer to recognize a taxable income or loss on any sale or exchange. For example, a taxpayer swapping BTC for ETH will owe taxes if the BTC appreciated between the swap and the time it was purchased. The use of stablecoins can minimize the changes for material income or loss generated by transactions, but since most fluctuate slightly above or below their peg, they cannot be counted on to fully eliminate the administrative burden of swapping digital assets.

In addition to stablecoins, a growing number of central banks are considering creating and issuing their own digital currencies. There are reports that around 80% of central banks are exploring the use of digital currencies, with some already in the testing phase.⁽³⁾ Chair of the U.S. Federal Reserve Jerome Powell has stated that the Federal Reserve will explore “the potential benefits and risks of [central bank digital currencies]. The key focus is on whether and how a [central bank digital currency] could improve on an already safe, effective, dynamic, and efficient U.S. domestic payments system in its ability to serve the needs of households and businesses.”⁽⁴⁾

In addition to digital assets such as BTC and ETH, ownership of a more traditional asset can be divided among its owners on a blockchain using digital tokens in the same way ownership of a company may be divided using shares. Such tokens are fungible and are tied to the value of the asset, which can be tangible (e.g., gold) or intangible (e.g., voting rights). Although there is no guidance on this topic, it seems likely that the IRS would treat such tokens as assets for tax purposes and require taxable income or loss to be recognized on any sale or exchange. The complexity and variety of transactions involving digital assets lead to an enormous amount of confusion when it comes to tax impact. Below are a few areas and open questions that could use further framework from Congress or the IRS:

- Digital assets earned from mining activities have to include in income the FMV of the earned asset as of the date of receipt—but what about those assets earned as rewards for staking to validate transactions in a proof of stake blockchain?⁽⁵⁾
- When a taxpayer deposits or withdraws liquidity for decentralized exchanges or DeFi platforms, does the exchange of a “liquidity provider token” make it a taxable exchange?⁽⁶⁾
- Receipt of an AirDrop triggers an income inclusion on the date of receipt. However, AirDrops occur with little or no warning, so recipients may be unaware they received anything of value.
- Does minting tokens—including creating wrapped tokens, publicly minting NFTs, or using one token as collateral to create another token (while retaining possession of the first token)—create a taxable event?
- How would the IRS respond if the Federal Reserve issues a “digital dollar”?

(1) Rev. Rul. 2014-21.

(2) Digital assets held as inventory or property mainly for sale to customers in a trade or business may be treated as generating ordinary income or loss.

(3) <https://www.coindesk.com/about-80-of-central-banks-are-exploring-cbdc-use-cases-bison-trail-report-says>.

(4) <https://www.federalreserve.gov/newsevents/pressreleases/other20210520b.htm>.

(5) A case regarding this issue was filed with the U.S. District Court for the Middle District of Tennessee on May 26, 2021 (*Jarrett v. United States*) and is still pending as of this writing.

(6) Liquidity provider tokens are generally provided as a type of receipt when providing liquidity. Such tokens generally do not have a market for trading.

U.S. Regulatory and Tax Environment

Within the digital asset space, the core U.S. regulatory agencies are the Securities and Exchange Commission (SEC), which oversees securities markets and investment contracts, and the Commodity Futures Trading Commission (CFTC), which oversees derivatives markets. Substantial uncertainty remains regarding the regulation of digital assets, which is currently split between the SEC and CFTC, depending on if transactions constitute an investment contract.

SEC Oversight

Investment contracts are defined by their ability to pass the four prongs of the Howey Test. The Supreme Court established this precedent in *SEC v. W.J. Howey Co.* where the Court stated that a transaction is defined as an investment contract if it is an investment of money, occurs in a common enterprise, carries the expectation of profit, and is derived from the efforts of others. If a transaction passes all four prongs, it falls within the purview of the SEC. Under this test, many cryptocurrencies and initial coin offerings (ICOs) are investment contracts and thus are under the oversight of the SEC.⁽¹⁾ This was tested in December 2020 when the SEC charged Ripple Labs in an enforcement action, stating that Ripple raised more than \$1.3 billion through unregistered digital asset sales (the sale of XRP tokens).⁽²⁾ A key Ripple defense has been that the XRP token does not pass the Howey Test, therefore not falling in the scope of the SEC. Litigation is still ongoing.

On April 11, 2022, the SEC published a Staff Accounting Bulletin (SAB No. 121) stating that entities that provide their users with the ability to transact in crypto assets should present a liability on their balance sheet to reflect the obligation of the firm to safeguard the assets and to protect cryptographic information.⁽³⁾ Furthermore, SEC staff believe that it would be appropriate to measure this safeguarding liability at initial recognition and each subsequent reporting date at the fair value of the crypto assets that a firm is responsible for holding for its platform users. This is similar to the regulatory reporting standards of traditional banking institutions. It is important to note, however, that an SEC SAB is merely a guideline on best practices and not a rule or regulation (although regulators like to preemptively telegraph upcoming changes so the public can modulate expectations). SAB No. 121 caused Coinbase to announce to shareholders via its 10-Q filings on May 10, 2022, that, based on its interpretation of how crypto assets need to be reported on the balance sheet, client assets would be at risk in a Coinbase bankruptcy.⁽⁴⁾ The day after this 10-Q was released, Coinbase's Nasdaq-traded common stock, COIN, closed more than 35% lower.

Houlihan Lokey's Financial and Valuation Advisory practices, such as Portfolio Valuation (providing valuations of digital assets for asset managers), Corporate Valuation Advisory Services (providing valuations to corporations), and Transaction Advisory Services (assisting corporations and trading platforms in navigating the tax effects), offer services to assist publicly traded firms that allow for digital asset transacting, such as Coinbase, Block, Robinhood Markets, Interactive Brokers, and BlockFi. These types of companies may see increased pressure to report and document their liabilities.

(1) "Framework for 'Investment Contract' Analysis of Digital Assets." DLT Framework, SEC, <https://www.sec.gov/files/dlt-framework.pdf>.

(2) "Press Release." SEC Charges Ripple and Two Executives with Conducting \$1.3 Billion Unregistered Securities Offering, SEC, 22 Dec. 2020, <https://www.sec.gov/news/press-release/2020-338>.

(3) Staff Accounting Bulletin No. 121, SEC, 8 Apr. 2022, <https://www.sec.gov/oca/staff-accounting-bulletin-121>.

(4) "Coinbase's 10-Q Filing." FORM 10-Q, SEC, 10 May 2022, <https://d18rn0p25nwr6d.cloudfront.net/CIK-0001679788/89c60d81-41a2-4a3c-86fb-b4067ab1016c.pdf>.

CFTC Oversight

The two largest, as defined by the market capitalization of minted coins, cryptocurrencies of Bitcoin and Ethereum are currently considered commodities, not investment contracts; thus, they are regulated by the CFTC—although the definition of commodity is not well defined in the Commodity Exchange Act (CFTC’s governing statute).⁽¹⁾ The CFTC has two types of legal authority: regulatory and enforcement. The CFTC does not regulate cash commodities (such as physical cows or barrels of oil) but rather derivatives products (such as futures and swaps). Despite cryptocurrencies like Bitcoin and Ethereum having cash commodities (BTC and ETH), this does not prevent the CFTC from being able to exercise enforcement authority over them using its anti-manipulation and anti-fraud provisions. The CFTC has used this to engage in a wide array of enforcement actions against schemes using digital assets—from BitMEX in 2015 to as recent as June 30, 2022.⁽²⁾

FASB and GAAP

The Financial Accounting Standards Board (FASB) is an independent organization that, alongside the Government Accounting Standards Board (GASB), developed GAAP. Although as of Thursday, August 4, 2022, no guidelines relating to digital assets have been published, on May 11, 2022, FASB added a project to its agenda on the topic of “accounting for and disclosures of digital assets.”⁽³⁾ Based on prior project timelines, it could take as long as two years for an exposure draft to be released to the public. The Association of International Certified Professional Accountants (AICPA) has published guidance from questions gathered between December 2019 and May 2021.

Taxation

Currently, the IRS’ guidance is limited to Notice 2014-21, 2014-1 C.B. 938, which defines virtual currency as “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.” Bitcoin is directly stated by the IRS and the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) to be a virtual currency. In Notice 2014-21, the IRS states that “virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency... Virtual currency [can be] a capital asset [although is not always].”⁽⁴⁾ This has led many experts, including Deloitte, to discuss how many digital asset transactions are currently treated as a barter exchange for U.S. income tax purposes.⁽⁵⁾ This includes the use of stablecoins to on- and off-ramp into fiat currency. Furthermore, in the same guidance from the IRS, they outline how virtual currency from mining counts as gross income. It also appears that the IRS views transactions with use digital assets the same as it does with fiat currency. In other words, unless otherwise stated, the medium of a transaction does not matter—only the supporting context of the transaction. Value is reported as of the transaction date. This makes the tax effects for investment managers rather straightforward, but due to the lack of targeted guidance as it relates to platforms, broker-traders, and other businesses with use digital assets as inventory, the tax effects for these businesses are not well defined.

(1) Stump, Dawn D. *Digital Assets: Clarifying CFTC Regulatory Authority & the Fallacy of the Question, “Is It a Commodity or a Security?”*. https://www.cftc.gov/media/6306/DigitalAssetsAuthorityInfographic_CommStump082321/download#:~:text=The%20CFTC%20does%20not%20regulate%20a%20digital%20asset%20even%20if,not%20it%20is%20a%20security%7D.&text=As%20the%20agency's%20middle%20name,based%20on%20a%20digital%20asset.

(2) “Release Number 8549-22.” *CFTC Charges South African Pool Operator and CEO with \$1.7 Billion Fraud Involving Bitcoin*, CFTC, <https://www.cftc.gov/PressRoom/PressReleases/8549-22>.

(3) “Project Update.” *Accounting for and Disclosure of Digital Assets*, FASB, <https://www.fasb.org/Page/ProjectPage?metadata=fasb-Accounting-for-and-Disclosure-of-Digital-Assets>.

(4) Calvin, Jim, *Taxation of Cryptocurrencies: Bloomberg Tax Management Portfolio No. 190*, 2019; citing Notice 2014-21, § 4, Q&A-1.

(5) “A Tax Lens on the Proliferation of Digital Assets.” *Deloitte United States*, Deloitte, 27 Oct. 2020, <https://www2.deloitte.com/us/en/pages/financial-services/articles/a-tax-lens-on-the-proliferation-of-digital-assets.html>.

Expectations and Future of the U.S. Regulatory Environment

The future of the U.S. regulatory environment will be shaped by regulatory and reporting agencies (SEC, CFTC, and FASB) as well as by direct federal action. Both legislation, such as the Responsible Financial Innovation Act, and executive action, such as President Biden's Executive Order 14067, will guide the expectations and allocations of crypto exchanges, asset managers and GPs, and institutional investors.

Executive and Legislative Acts

On March 9, 2022, President Biden signed his Executive Order 14067 regarding the responsible development of digital assets.⁽¹⁾ Key takeaways from the order include requiring that the Department of the Treasury study, create plans for, and report on the future of money and the potential impacts of a U.S. central bank digital currency (CBDC) as well as policy recommendations around consumer protection and financial inclusion issues. It also calls for the Financial Stability Oversight Council (FSOC) to produce a report within 210 days on financial stability risks and regulatory gaps.⁽²⁾ The current administration's interest in a U.S. CBDC is limited in scope in research and development but not in direct action or the rule-making of digital assets—yet. Once implemented, a CBDC's effects will likely only be material for commercial banks (not investment banks or investment managers) per an analysis by Deloitte published on July 8, 2022.⁽³⁾

On June 7, 2022, Senators Kirsten Gillibrand and Cynthia Lummis (member of the Senate Banking Committee) introduced the Responsible Financial Innovation Act.⁽⁴⁾ Highlights from this proposed act include making clear distinctions between digital assets, determining which are securities and which are commodities, increasing the CFTC's role in digital asset spot markets, increasing regulatory requirements for stablecoins, creating an advisory committee for digital assets, creating a tax structure for digital assets where miners are not considered brokers, and directing the Department of Defense to study the security of the digital yuan (China's CBDC). The act would apply to corporations, businesses, crypto brokers, broker-traders, and any other parties that engage in transactions of digital assets.⁽⁵⁾

SEC

In a speech on April 4, 2022, SEC Chair Gary Gensler stated that platforms, including crypto-only trading platforms, are trading securities and that it is a goal of the SEC to regulate these platforms in the manner in which traditional exchanges are regulated. Additionally, the SEC views stablecoins as facing the same regulatory backdrop as money market funds, as well as additional KYC and AML scrutiny, due to their prevalence in on- and off-ramping with the fiat banking system.⁽⁶⁾

(1) "Fact Sheet: President Biden to Sign Executive Order on Ensuring Responsible Development of Digital Assets." The White House, The United States Government, 9 Mar. 2022, <https://www.whitehouse.gov/briefing-room/statements-releases/2022/03/09/fact-sheet-president-biden-to-sign-executive-order-on-ensuring-responsible-innovation-in-digital-assets>.

(2) Biden, Joseph R. "Executive Order on Ensuring Responsible Development of Digital Assets." Executive Order on Ensuring Responsible Development of Digital Assets, The White House, 9 Mar. 2022, <https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets>.

(3) "What Are Central Bank Digital Currencies?" Central Bank Digital Currencies: The next Disruptor, Deloitte, 6 July 2022, <https://www2.deloitte.com/global/en/pages/financial-services/articles/cbdc-central-bank-digital-currency.html>.

(4) Lummis, Cynthia. "Lummis, Gillibrand Introduce Landmark Legislation to Create Regulatory Framework for Digital Assets" Senator Cynthia Lummis." Lummis, Gillibrand Introduce Landmark Legislation to Create Regulatory Framework for Digital Assets, Senate.Gov, 14 June 2022, <https://www.lummis.senate.gov/press-releases/lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets>.

(5) Snell & Wilmer. 10 Key Points of the Lummis-Gillibrand Crypto Bill. JD Supra, 17 June 2022, <https://www.jdsupra.com/legalnews/10-key-points-of-the-lummis-gillibrand-8522356>.

(6) Gensler, Gary. "Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference." SEC.Gov, SEC, 4 Apr. 2022, <https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422>.

The SEC Division of Enforcement's Crypto Assets and Cyber Unit will increase its head count by 20 (to 50 total staff) in 2022, with these new hires including investigative staff attorneys, trial lawyers, and fraud analysts. Digital assets are also a Division of Examinations (EXAMS) stated priority for 2022, per its 2022 Examination Priorities Report. EXAMS' focus will be on RIAs that offer digital assets as well as mutual funds and exchange-traded products, which offer exposure to crypto assets.⁽¹⁾

CFTC

No material forward guidance from primary sources, such as CFTC Commissioners or official press releases, have been found regarding CFTC rule-making or enforcement action.

FASB and GAAP

Currently, under GAAP, crypto assets are reported as intangible assets. This is creating issues for broker-trader firms or platforms such as Voyager, which buys and sells crypto assets principally for the purpose of executing customer crypto asset trades.⁽²⁾ Per International Financial Reporting Standards (IFRS), they report these assets as "inventories," which requires broker-traders to measure inventory "at fair value less cost to sell." However, crypto assets need to be accounted for under Topic 350 as "Intangibles—goodwill and other." This does not carry the same accounting standard of requiring valuation when reporting to be "at fair value less cost to sell."⁽²⁾ Furthermore, crypto assets often contain financial instrument properties that differentiate them from other intangible assets. Between the intra-line-item differences and the gap between GAAP and international standards like IFRS, the FASB is likely to see increased pressure to further clarify or change the reporting of digital assets.

Taxation

The IRS has already taken aggressive measures to mitigate tax avoidance, and we are likely to only see stronger stances moving forward. This has included using the courts to require crypto platforms such as Coinbase to release transaction information on its users.⁽³⁾ In an interview on March 23, 2022, EY Global Blockchain Tax Leader Dennis Post stated that "we should expect more tax reporting obligations coming from tax administrations across the globe in the very near term" with core focuses surrounding the fact that "purchase, ownership, and sale vary widely between jurisdictions, embedding an unnerving level of ambiguity, complexity, and risk that individuals and corporate tax teams must navigate."⁽⁴⁾ The recently signed U.S. Infrastructure Investment and Jobs Act tries to address some of these issues as well as the underreporting of transactions by putting the onus on brokers to report. Although in the U.S. and U.K., subjecting cryptocurrency investments to capital gains is not changing, other nations like Japan and New Zealand have shown that this is not the sole way of taxing cryptocurrency, with both nations taxing it via an income tax approach. Although the IRS has not provided guidance yet, staking is subject to income tax in the U.K. as well as in the U.S.⁽⁴⁾ Lastly, NFTs are not clearly defined but rather taxed most often like other digital assets or cryptocurrency, although this changes depending on the instance. NFTs have been taxed as property, commodities, and securities—all of which can generate their own direct and indirect tax consequences.

In summary, although there is no IRS forward guidance found outlining its priorities, based on research by legal and tax experts (such as EY and Deloitte), expect staking, NFTs, and broker reporting to have further taxation rules and regulations.

(1) "2022 Examination Priorities." SEC.Gov, SEC, 31 Mar. 2022, <https://www.sec.gov/files/2022-exam-priorities.pdf>.

(2) Voyager. "Response to the FASB Invitation to Comment." FASB.org, FASB, 22 Sept. 2021, <https://www.fasb.org/document/blob?fileName=AGENDACONSULT.ITC.097.VOYAGER%20DIGITAL%20LTD.%20MIGLE%20BUKAUSKAITE,0.pdf>.

(3) Kirk, Matt. "Planning for the Future: Estate and Tax Planning with Digital Assets: Insights." Holland & Knight, Holland & Knight, 10 June 2022, <https://www.hkllaw.com/en/insights/publications/2022/06/planning-for-the-future-estate-and-tax-planning-with-digital-assets>.

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