FROM	Crypto Council for Innovation
TO	European Commission
SUBJECT	**European Commission's Proposal for a Council Directive amending Directive 2011/16/EU on administrative cooperation in the field of taxation (DAC8)**
DATE	**March 8, 2023**

Dear European Commission,

The Crypto Council for Innovation ("**CCI**") welcomes the opportunity to contribute to the public consultation on the *European Commission's Proposal for a Council Directive amending Directive 2011/16/EU on administrative cooperation in the field of taxation (DAC8)* (the "**Consultation Document**" or "**Proposal**").

About Crypto Council for Innovation

The Crypto Council for Innovation (CCI) is an alliance of crypto industry leaders with a mission to communicate the benefits of crypto and demonstrate its transformational promise. CCI members include some of the leading global companies and investors operating in the crypto industry. CCI members span the crypto ecosystem and share the goal of encouraging the responsible global regulation of crypto to unlock economic potential, improve lives, foster financial inclusion, protect national security, and disrupt illicit activity.

We have outlined general and specific comments related to the Consultation Document and remain at your disposal to further elaborate on them and share our views concerning reporting requirements.

A summary of our key comments is included in the box below:

- **Additional details on the interaction between DAC8 and CARF are needed**, especially where there is definitional ambiguity or incongruity between the rules and in light of the likely issuance of administrative guidance on CARF at the level of the OECD/G20 Inclusive Framework.

- **Sandboxes and phase-in approaches should be considered** to facilitate implementation and compliance with the rules by smaller players. This will avoid stifling innovation and discouraging new players from entering the market.

- **Only NFTs that refer to or are used as financial instruments should be considered reportable crypto assets**. Currently, most NFTs relate to collectibles, digital art, or credentials, and none of these items are treated as financial in the "physical" economy. In this context, we would also like to underline that Regulation MiCA excludes NFTs from its scope due to valuation and other difficulties.

- **It would be useful to clarify whether DAC8 also covers resident users** and, if so, how that obligation interacts with other reporting obligations that may already exist in the relevant jurisdiction.

- **The Directive should include an express definition of a "Crypto-Asset Operator"** in Section IV(B)(2) of Annex VI. At the moment, this is only included in the Explanatory Memorandum, which reads as follows: "A crypto-asset operator means any natural person, legal person or undertaking whose occupation or business is the provision of one or more crypto-asset services to third parties on a professional basis but who is not covered by the scope of Regulation XXX".

- **The application of DAC8 rules in the context of Decentralized Finance, and in general non-custodial service providers, is not clear, and additional reflection is needed** to clarify the conditions and criteria to identify those subjects that are obliged to report relevant tax information. We believe that tax reporting obligations should be imposed only on those that are obliged to carry out KYC or similar customer due diligence procedures according to the applicable rules.

- **The reporting timeline is very tight and should, at a minimum, be aligned with those under the CRS**, according to which financial institutions must report the details of financial accounts to tax authorities by 30 June following the end of the tax year.

- **We suggest waiving penalties for the first three years**, providing exemptions for good faith mistakes, and penalty protection for intermediaries who relied on others' compliance.

I. General Comments

We welcome the fact that the Consultation Document is largely based on concepts and due diligence requirements derived from the *Crypto-Asset Reporting Framework* ("**CARF**") published by the OECD on 10 October 2022.

As further elaborated below, we recommend aligning DAC8's provisions to those of CARF, as this will reduce the burden on intermediaries and ensure a consistent implementation of the Model Rules developed under the auspices of the G20 and of the OECD.

At the same time, we believe that sandboxes and phase-in approaches should be considered to facilitate implementation and compliance with the rules. For example, DAC8 rules could exempt new entrants which meet certain conditions for the first periods of operation and then impose reporting requirements when they are more established. In this sense, the imposition of reporting requirements could be phased in after appropriate lead time has been provided to start-ups and newcomers. This will avoid stifling innovation and discouraging new players from entering the market with new ideas and solutions.

We also consider that further guidance on the interaction between DAC8 and CARF is very much needed. Specifically, when there is definitional ambiguity or incongruity between the rules, it should be clarified whether the explanations included in the Commentary to the CARF Model Rules also apply to DAC8 reporting requirements. This aspect is even more crucial concerning the implementation guidance and further clarifications that will be issued over time by the OECD/G20.

II. Specific Comments

A number of specific issues raise concerns from our perspective. These relate primarily to the following: (a) crypto-assets in scope and the coverage of NFTs; (b) crypto-asset users covered; (c) intermediaries in scope and the application of the rules to DeFi; (d) reporting requirements related to valuation and timing issues; (e) due diligence requirements on the place of birth information of individual users; and (f) financial penalties.

a) <u>Crypto-Assets in Scope and coverage of NFTs</u>

We appreciate that the definition of Crypto-Asset under DAC8 is aligned with that under Regulation MiCA[1], which refers to "*A digital representation of a value or a right which may be transferred and stored electronically, using distributed ledger technology or similar technology.*" A Crypto-Asset is relevant for DAC8 reporting if it qualifies as a **"*Reportable Crypto-Asset,"*** which is defined as "*Any Crypto-Asset other than a Central Bank Digital Currency, Electronic Money, Electronic Money Token or any Crypto-Asset for which the Reporting Crypto-Asset Service Provider has adequately determined that it cannot be used for payment or investment purposes."*

However, we have concerns that the definition may include NFTs within the scope of DAC8 reporting obligations. An NFT is a non-fungible token on the blockchain that serves as a record of ownership or authenticity for an associated file, which is typically an image or other media. We believe that only NFTs that either refer to or are used as financial instruments should be covered as "Reportable Crypto-Asset[s]. In this respect, when interpreting the definition, the Commentary to the CARF Model Rules assumes that "*NFTs that are traded on a marketplace can be used for payment or investment purposes and are therefore to be considered Relevant Crypto-Assets."*[2] Overall, the fact that a digital item is bought, sold, or transferred using a Web3 marketplace or a blockchain should not be dispositive in determining whether the asset "can be used for investment or payment purposes." For example, NFTs that clearly point to financial assets or are being used analogously to financial instruments should be reportable. However, the majority of the digital items

[1] *Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937 (MiCA)* as it reads in the text adopted by the Permanent Representatives' Committee meeting of 5 October 2022.

[2] See *Crypto-Asset Reporting Framework* Commentary on Section IV, Subparagraph A(2)(12).

and media currently associated with NFTs fall under classifications of collectibles, digital art, or credentials, and none of these items are treated as financial in the "physical" economy.

In this context, we would also like to underscore that Regulation MiCA excludes NFTs from its scope due to valuation and other difficulties. It does so by stating that "*This Regulation should not apply to crypto-assets that are unique and not fungible with other crypto-assets, including digital art and collectibles, whose value is attributable to each crypto-asset's unique characteristics and the utility it gives to the token holder."* The reason behind the express exclusion, according to MiCA itself, is that "*While these crypto-assets might be traded in market places and be accumulated speculatively, they are not readily interchangeable and the relative value of one crypto-asset in relation to another, each being unique, cannot be ascertained by means of comparison to an existing market or equivalent asset. Such features limit the extent to which these crypto-assets can have a financial use, thus limiting risks to users and the system, and justifying the exemption".*[3]

In addition, the significance of the term "marketplace" should be clarified by providing examples and practical cases. For instance, video game platforms, where in-game NFTs are exchanged among users within a closed loop, should fall out of the scope since these assets, although listed in a marketplace, do not have a readily-available value in fiat.

The risk of a broad interpretation of the term is to render the reference to "payment or investment purposes" meaningless in practice and, hence, to oblige intermediaries to provide information of little value to tax administrations. Therefore, it is of utmost importance to provide objective criteria to identify which NFTs are relevant for DAC8 reporting obligations, possibly with examples of existing NFTs that would be covered or excluded.

b) **<u>Crypto-Asset Users in scope</u>**

It is unclear whether the definition of the Consultation Document includes users that are residents in the same Member State of the Crypto-Asset Service Provider. Section V(A)(1) of Annex VI to the Proposal states that "*Member States shall take the necessary measures to require Reporting Crypto-Asset Service Providers to enforce the collection and verification requirements under Section III in relation to their Crypto-Asset Users.*" Hence, it appears to refer to all crypto-asset users of the relevant reporting intermediary, including resident users. In addition, the explanatory memorandum of the Consultation Document appears to confirm such intent when it states that "*Reportable transactions are exchange transactions and transfers of reportable crypto-assets. Both, domestic and cross-border transactions are in the scope of the proposal and are aggregated by type of reportable crypto-assets".*[4] It is worth noting that CARF Model Rules apply only to non-resident crypto-asset users. This is because domestic legislation often covers reporting obligations on resident users, which can also be tailored to the relevant substantial tax treatment.

It would be useful to clarify whether DAC8 also covers resident users and, if so, how that obligation interacts with other reporting obligations that may already exist in the relevant jurisdiction. This is of particular relevance, on the one hand, to ensure that intermediaries do not need to duplicate reporting efforts and, on the other hand, that tax administrations obtain information that is relevant for their purposes.

c) **<u>Intermediaries in Scope</u>**

The Consultation Document covers Crypto-Asset Service Providers as defined in Regulation MiCA and Crypto-Asset Operators that do not meet the conditions authorized under the Regulation. Such intermediaries are subject to DAC8 reporting requirements if they

[3] See recital (6b) of the *Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937 (MiCA)*.
[4] See page 12 of the Explanatory Memorandum of the Consultation Document.

provide one or more crypto-asset services [5] to EU crypto-asset users. The Consultation Document refers to Crypto-Asset Operators as a residual category compared to **Crypto-Asset Service Providers,** which, by contrast, are defined by reference to Article 3(8) of the Draft Regulation MiCA. Indeed, Section IV(B)(2) of Annex VI provides that "***Crypto-Asset Operator***" means "*a provider of Crypto-Asset Services other than a Crypto-Asset Service Provider*." The explanatory memorandum, in contrast, contains a definition of a **Crypto-Asset Operator,** which reads as follows: "*A crypto-asset operator means any natural person, legal person or undertaking whose occupation or business is the provision of one or more crypto-asset services to third parties on a professional basis but who is not covered by the scope of Regulation XXX*."[6]

The definition in the explanatory memorandum is not part of the proposal's legislative text, and we recommend including it in Section IV(B)(2) of Annex VI to avoid confusion. As it stands today, the definition does not clarify the perimeter of covered subjects and, consequently, creates confusion regarding the range of obligated entities and individuals. This risks generating conflicts regarding the interpretation of the relevant provisions and an inconsistent application across countries, thus affecting the initiative's potential for success.

This lack of a definition also risks burdening smaller entities and non-professional operators, which the reporting obligations should clearly not capture. In fact, the absence of adequate criteria to identify the subjective scope of the rules could, in theory, be read as wanting to attract into the reporting regime non-professional operators and other small players that do not operate in the course of their professional or business activities but simply contribute, often for free, to the development of a nascent eco-system. This appears to go against the EU's current public policy to give small players a fair chance to compete with larger players. Indeed, small, non-professional crypto-asset operators do not have sufficient economic and technical resources to comply with the reporting requirements and may be overburdened by DAC8 reporting obligations. Imposing obligations on them will help strengthen the already-powerful players' market position and counter digital assets' decentralized ethos.

This risk is even more prominent in the context of Decentralized Finance, whose coverage remains largely unclear at this stage. We believe that additional reflection is needed on applying DAC8 rules in the context of DeFi. If DAC8 is intended to apply also to decentralized platforms, clarifications are needed regarding the conditions and criteria to identify those subjects that are obligated to report the relevant tax information. There is no explicit provision in DAC8 in this regard; this is also inconsistent with CARF, which qualifies Reporting Crypto-Asset Service Providers as individuals or entities that, as a business, provide exchange services for or on behalf of customers by "*making available a trading platform*."[7] In this regard, the CARF Commentary explains that an individual or entity is considered to make available a trading platform if it exercises control or sufficient influence over the platform. These concepts are to be assessed in a manner consistent with the 2012 FATF Recommendations, which provide that factors to be taken into account include whether any party makes profits from the service rendered or can set or change the guidelines for identifying the owner/operator of a DeFi arrangement.[8]

If these explanations are meant to be also applicable in the context of DAC8, we consider it important to state so expressly and to provide detailed guidance on the interpretation and application of these concepts. To this aim, an analysis of the main DeFi platforms and related white papers could be carried out to outline the criteria under which an entity or individual should be considered as a crypto-asset operator rather than a user merely contributing to the development of a common initiative. In this respect, it should be acknowledged that several decentralized exchanges utilize governance tokens that allow token-holders to put forth proposals that could influence the platform or protocol's features (*e.g.*, in the case of DAOs). These

[5] Crypto-asset services are defined under Article 3(9) of the Regulation MiCA.
[6] See page 11 of the Explanatory Memorandum of the Consultation Document.
[7] See CARF Model Rules, Section IV(B)(1): "*The term "Reporting Crypto-Asset Service Provider" means any individual or Entity that, as a business, provides a service effectuating Exchange Transactions for or on behalf of customers, including by acting as a counterparty, or as an intermediary, to such Exchange Transactions, or by making available a trading platform*."
[8] See CARF Commentary on Section IV, Subparagraph B(1)(27).

token-holders should not be burdened with reporting requirements, and this should be stated clearly. Further, the rules should recognize that decentralized exchanges often deal with pseudonymous wallets, and in many instances, obtaining and reporting data on these users is not feasible. We want to stress that under current rules, DeFi platforms are not obligated to engage in KYC or similar customer due diligence procedures when onboarding users. Given that compliance with reporting requirements for DeFi platforms is simply impossible, we recommend applying the same criteria that are used to determine whether AML/CFT are applicable to require tax reporting only when this is the case, i.e., in case of those claiming to be decentralized but where ultimately it is possible to identify persons that control the platform and exercise a significant influence on it.[9]

The same solution should be adopted across the board, for example, in relation to non-custodial crypto assets providers. In other words, it should be clarified that all intermediaries not obligated to carry out KYC checks under the applicable AML/CFT regulations should not be in the scope of DAC8. This may be particularly relevant for non-custodial service providers where the customer is the only one to have access to the private keys.

Finally, we have some doubts regarding the alignment among different definitions.

The definition of Reporting Crypto-Asset Service Provider means "*any Crypto-Asset Service Provider and any Crypto-Asset Operator that conducts one or more Crypto-Asset Services permitting Reportable Users to complete an Exchange Transaction and is not a Qualified Non-Union Reporting Crypto-Asset Service Provider.*"[10] However, the definition of Reportable Transactions means "*any Exchange Transaction and transfer of Reportable Crypto-Assets*."[11] This definition of Reportable Transaction implies that there may be some transactions that are not Exchange Transactions but nevertheless are still Reportable Transactions. Taken altogether, the alignment of definitions would lead one to conclude that if a service provider only supplies services other than Exchange Transactions, it would not qualify as a Reporting Crypto-Asset Service Provider subject to DAC8 reporting obligations, even if that service provider is nevertheless permitting Reportable Users to complete a Reportable Transaction. If this is the case, it should then be made explicit. In any case, in our opinion, the current incongruity in definitions risks creating an unlevel playing field and inadvertently driving business model decisions.

d) **<u>Reporting requirements</u>**

Subject to what is stated above regarding their coverage, identifying a fair market value may be very challenging for NFTs. The valuation process is arduous and subjective. Unlike many other crypto-assets, NFTs are, by definition, unique and have media or digital content associated with them, making valuation arduous on an individual basis and practically impossible at scale. For example, a single NFT's history (i.e., past ownership of the NFT, as recorded on the blockchain) and the rarity of certain traits in associated media impacts its valuation significantly. We, therefore, recommend limiting the coverage to crypto-assets that can be used for payment or investment purposes and are actively traded. As mentioned above, this is also recognized by Regulation MiCA.

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[9] In general, we believe that it is not desirable regulating decentralized finance in the same way as centralized finance: a tailored regulatory framework for De-Fi is necessary, which should regulate the centralized/business-owned applications (i.e., the business operating end-user-facing software that provide access to protocols), not the protocols or software themselves (i.e., the underlying decentralized blockchains, smart contracts, and networks that provide the Internet with new native functionality). If regulators impose subjective and globally-inconsistent regulations on DeFi protocols, it could stifle innovation in decentralization. See also the Written Testimony of Linda Jeng, J.D., Before the U.S. Senate Banking Committee on the "Crypto Crash: Why Financial System Safeguards are Needed for Digital Assets", Tuesday, February 14, 2023 available at https://www.banking.senate.gov/imo/media/doc/Jeng%20Testimony%202-14-23.pdf. More information about this topic is included in Regulate Web3 Apps, Not Protocols Part II: Framework for Regulating Web3 Apps, Miles Jennings and Brian Quintenz available at https://a16zcrypto.com/regulate-web3-apps-not-protocols-part-ii-framework-for-regulating-web3-apps/.

[10] See *Consultation Document*, Section IV of Annex VI

[11] Id.

Regarding valuation, another critical issue that is relevant for all crypto-assets in scope is to determine at what point in time to ascertain the market value of a crypto-asset for reporting purposes. Although intermediaries often maintain valuations, challenges may arise due to different approaches by different intermediaries (for instance, the value at the beginning of the day, at the end of the day, at a specific point in time during a day, or an average during the day). Therefore, an agreed reconciliation mechanism could be considered and outlined in detail to avoid mismatches and potential errors.

The reporting timeline is very tight and should, at a minimum, be aligned with those under the CRS. Currently, the DAC8 Proposal requires intermediaries to report the relevant information to the competent authorities no later than 31 January of the year following the calendar year to which the information relates. By contrast, CARF does not explicitly provide for a reporting deadline. Under the CRS, financial institutions must report the details of financial accounts to tax authorities by 30 June following the end of the tax year. Providing a more reasonable timeline would allow intermediaries to check the accuracy of the information collected and be able to resolve any issues beforehand.

e) **Due Diligence requirements**

We recommend aligning the reporting of the place of birth information to the local jurisdiction KYC requirement. Section II(B)(1) of Annex VI to the Proposal requires intermediaries to report the place of birth of Crypto-Asset Users that are individuals. However, the same information is not listed in the information to be included in the self-certification for its validity, as provided under Section III(C)(1) of the Annex VI to the Proposal. However, not all jurisdictions require the place of birth to be collected as part of KYC. For this reason, CARF Model Rules provide an exemption from this specific reporting requirement unless the Reporting Crypto-Asset Service Provider is required to obtain and report it under domestic law, and it is available in the electronically searchable data maintained by the Reporting Crypto-Asset Service Provider.

f) **Financial penalties**

DAC8 places a strong emphasis on penalties. This is important to ensure a level playing field, and we welcome that. However, we recommend that penalties be waived during the first three years of application of the rules to a given Reporting Crypto-Asset Service Provider and that a specific set of exemptions be introduced in case a Reporting Crypto-Asset Service Provider has made reporting mistakes in good faith. A system of penalty protection would, for example, be necessary in case an intermediary does not comply after having obtained assurance that another Reporting Crypto-Asset Service Provider fulfills the reporting requirements concerning a certain Crypto-Asset User (as provided by Article 8ad(6) of the Proposal), but the latter ceases to exist, *i.e.*, following, for instance, a bankruptcy. In such a case, intermediaries who relied in good faith on their compliance should not be subject to sanctions.

Sincerely,

/s/ Linda Jeng

Linda Jeng
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Crypto Council for Innovation