Lowenstein's Tech Group Podcast: Crypto Innovators

Episode 8 –

Tax Hygiene Part 2: Additional Insights from Bitwave on Accounting For Crypto Companies

By Eric Swartz, Leah Satlin, Pat White

DECEMBER 2022

Kevin Iredell: Welcome to the Lowenstein Sandler podcast series. I'm Kevin Iredell, Chief Marketing Officer at Lowenstein Sandler. Before we begin, please take a moment to subscribe to our podcast series at lowenstein.com/podcasts. Or find us on iTunes, Spotify, Pandora, Google podcast, and SoundCloud. Now let's take a listen.

Eric Swartz: Welcome to the Crypto Innovators podcast, presented by Lowenstein Sandler's Crypto practice. I'm your host, Eric Swartz, senior counsel and vice chair of Lowenstein Crypto. We're speaking with the most innovative founders and operators in Web3 to shine light on the technologies that fascinate us all. I'd like to introduce you to your other host, Leah Satlin.

Leah Satlin: Hi, everyone. I'm Leah Satlin, Tech Group counsel specializing in IP and commercial contracts.

Eric Swartz: Today, we welcome Pat White, CEO at Bitwave, for part two of our conversation about Bitwave's incredible Web3 accounting solutions. Can you tell us a bit more about Bitwave's NFT accounting solutions?

Pat White: Yeah, I'm actually really proud of this part of the world because accounting for NFTs is insanely difficult in so many different ways. First of all, this is another place where the accounting rules are incredibly murky and you're plumbing the depths of the FASB guidance and IRS guidance and all this kind of stuff. So that's part of it.

Pricing is really, really tricky and we can talk about that in a little bit, but if you think pricing for tokens is hard, pricing for NFTs is 10 times harder than that. And then third, and this is something I'm actually really proud of, the spam is really bad and it's getting kind of worse. So we deal with a lot of customers that are well-known folks, that are known people in the industry. One of them gets something like a thousand spam NFTs a day.

And in an accounting system, no one has to deal with that. QuickBooks has never had this issue where someone got so many spam money sent to them. You're not getting wires in, like, "Oh, I got $3,001 wires in today. What do I do with it?" This isn't a problem anyone's ever had to deal with before. But on the blockchain it is because it's so cheap to send these transactions and it's such a good way to advertise.

So we actually built what I think is the world's first ever NFT and token spam filters. We actually have a full spam filter. Because, I mean, part of what's cool about Bitwave is we support any token we see, NFT, ERC-20, you name it, we support it out of the box. We can support basically anything that we see on the blockchain. You don't have to wait for Bitwave to add support for a token. We just pick it up. We might have to do some work to get at pricing, but you'll see it in your register.

And so we actually had to go and build a spam filter that basically filtered out all these NFT spam that was coming in. We do a score based on is it on OpenSea? Is it on Rarible? Is it in one of the different platforms? How much transfer volume? How centralized is it? Things like that. We turn that into a spam score and then we'll actually filter those transactions out. So we have full ability to recognize NFT purchases. This gets back to what I was talking about in terms of our gain/loss engine.

So because we can look at any number of assets on either side, when you send a fee and you pay some ETH and you acquire an NFT, to us that's just a token to token transfer, just like any other one. It's just so happens the NFT might not have a cost basis associated with it that's fair market valuable. You might not have the ability to fair market value the NFT when you buy it. But in that case, we'll just pick up a zero fair market value and we'll carry forward the cost basis from the disposed assets automatically in that situation.

We have the ability to start adding pricing for those NFTs. I imagine, this is kind of a funny world that it hasn't quite happened yet, but I do imagine a world where NFTs will eventually kind of be more specifically priced. You'll kind of be almost in a way that you would do a yearly review of any real property, like real estate property you're holding. You would bring in some sort of appraiser to sort of look at all your real estate property and figure out fair market value. And that's what you would put in your books. I imagine a world where that happens with NFTs, but instead of someone in a suit, it's a 23-year-old with a backwards trucker hat smoking a j, who throws his feet up on the desk and just is like, "Bored Ape's super hot. Mark that up. CryptoPunks' not hot. Mark that down." It's kind of a world where I kind of imagine there'll be this more appraisal driven function at some point.

There are more scientific ways of getting into NFT pricing because essentially the base things that they give you for NFT prices, you have a floor price, which is what is the cheapest of this NFT collection that was sold in the last 30 days. But no one wants to use the floor price as pricing because it means everyone will pick up an immediate impairment, right? Because the floor price is necessarily the lowest cost and it's also the lowest cost. It's not an offer to buy. It is a past sale. So you can't really use it for US gap pricing purposes anyways.

So we've developed a few different algorithms that use ratios or averages or whatever it is that allow you to do kind of pricing and we're still building a lot of this stuff out, which is a really fun part of the entire world here. But we do have very good support for FMTs and the world's first token spam engine, I guess you would call it.

Eric Swartz: Yeah, I mean, the spam engine is crucial because I know exactly what you're talking about. I mean, the amount of just random tokens that folks are receiving and then obviously even worse is with the dusting with Tornado Cash. And then I would imagine a world where almost you would want to run through some sort of filter before it even could get to your wallet because of that exact problem.

Pat White: That's a cool idea. I like that.

Eric Swartz: And almost have a way to have it transferred to your wallet after the fact, but at least it never touches your wallet initially. Because I think that that's super crucial after that dusting issue and literally these people have reporting obligations for the rest of their lives because of this. This is no joke, like a huge problem. So the solution that you guys have built is amazing and I think it's going to get a lot of use after that.

Pat White: The dusting issue is one of my favorite recent issues, to be quite honest. I actually really enjoyed it. I am not a hardcore crypto libertarian or anything like that. I'm like a deep pragmatist in this space. Businesses are getting into crypto because of marginal efficiencies. Businesses don't take ideological stances. Michael Saylor and Elon Musk are notable exceptions. But businesses like Walmart aren't getting into crypto because they want to burn down the Federal Reserve. In fact, I think Walmart is quite fond of the Federal Reserve.

They're getting into crypto because someone like Walmart looks at their supply chain and honestly asks the question, "If we move to smart contract-based invoicing, could we shave 1% off of a trillion dollar supply chain?" If they shave 1% off a trillion-dollar supply chain, that's real money. I'm no scientist, but that's some real money that you're sitting on right there. Those are the questions that they're asking.

And so the way I tend to think about crypto regulation and what I really like about crypto is you have companies like Bitwave that are doing a best effort, good faith effort to comply with everything that they can. So that's the nature of building an accounting product here is it's not going to be perfect. The world is imperfect and so you are doing the absolute best that you possibly can as part of it.

Something like OFAC is not like that. OFAC is a very, very large hammer to bring down. And it's like the penalties for dealing with sanctioned addresses in the US are incredibly severe. I don't love the Tornado Cash thing because I thought it was incredibly poorly executed. And to the extent that OFAC, which never releases FAQs, released an FAQ, whatever it was, a month after it to clarify a lot of things like is it okay for you to mine blocks, how are miners and things like that impacted by this?

But what I like about crypto, and the reason OFAC ultimately had to do that, is that crypto, it has a release valve. If I get sanctioned, all the US banks have to stop sending me money. The US financial rail system does not have a release valve. OFAC has an incredible amount and the Treasury Department and the Fed have an incredible amount of control over the US banking system. Crypto, if you do something like sanction Tornado Cash, you can dissuade a certain number of people in America from using it, but Tornado Cash still does a huge amount of volume every single day. You can't censor this stuff, you can't stop this happening.

So regulation, realistically, there's a relief valve on really severe regulation where you can pass the law. Iran has a law decision, you're not allowed to use Bitcoin. There are still Bitcoin miners in Iran. You can see it off their IP addresses. And so you basically in the situation where laws are adhered to by people who want to adhere to them, but if you pass a law that's overly strenuous, people just will leave the US, or they won't domicile here, or they'll just ignore the rule because it's essentially unenforceable.

And I think that's good. There's a part of me that really likes that. It likes the idea of regulation that is sensible and followed by people who are genuinely trying to follow and do the right thing without it being overly onerous. And I think that's why we haven't seen crypto regulation come down with a hammer in the US because the US does tend to be relatively pragmatic. And it would just be like, "Okay, well, we're not going to follow this regulation, everyone move on with your lives and now we're just not going to report taxes at all in the US because it becomes a bigger risk for us to report US taxes because of really severe regulation than not. So we'll just domicile in the BVI and not report taxes."

So it's this really interesting kind of game theory game of chicken that everyone's playing right now. But I think it's gotten to a really nice equilibrium, in my kind of humble opinion, between the regulation that we're seeing and the actual act of it. And part of that is just the pragmatic piece of it, which is really cool to see.

Eric Swartz: Agreed. I think that we'll see a lot of sort of evolution as folks start to understand these technologies more within the legislative branch. And I think at some point we'll have some solutions that make a bit more sense than what currently exists. But I agree with you that there are a lot of folks that sort of have decided to avoid the US and I think that's the exact wrong outcome and that's not what the regulators really want or the legislature really wants. So I agree. I think there's going to be a lot more acceptance of how these technologies work and then also an attempt to work within the confines of these technologies and the efficiencies that they produce while also guaranteeing some of the safeguards that the laws provide. So I mean, I couldn't be in agreement more.

And honestly, the vast majority of our clients are very much so like Bitwave in that they are very compliance-focused, and they are within that first camp where they are trying their best to comply. And so we sort of really encourage that type of behavior. And we also understand though that the space is kind of ever changing and evolving and there's a lot of folks that can't or just don't have a path to compliance. And so for them, we also understand the need to have an offshore presence and set up offshore where these activities are permissible and where there's less risk for the business.

Pat White: That's just the thing, is that's why the US has been surprisingly non-knee-jerk reactive. I don't know how else to say it. Normally in these situations, the US would be the first to knee jerk, but they recognized very early on that there's a world-level competitive advantage to not ceding crypto to the Virgin Islands or to Mallorca, or wherever it is in the world that this is happening. It's one of those things, when I talk about DeFi, the US, it's something like 30% of our GDP, maybe it's not that high, 20% or whatever, is from the financial services industry. I mean, we are a services-based economy and one of the major contributors to that is Wall Street moving ones and zeros around. And DeFi, fundamentally, is a threat to essentially US financial hegemony, which we really have right now. I mean, there's no one else in the world that even is close to how much money we move around the world.

And so there's sort of two ways it could have gone. You could have seen enormous rent seeking where all of the Wall Street banks immediately pushed hard to outlaw all of this stuff and it was completely illegal and you go to jail for touching it. Or you could have seen this the other way is that we kind of embrace it with the notion that if we want to maintain some sort of hegemonic influence over this, we have to be the leaders and not the followers on it. We again, surprisingly, picked that avenue. Now, that doesn't mean we'll stay that way. Now that Wall Street's a little bit more waking up to it, maybe that changes. But up to this point, that has been the situation, which is really cool. Good for America on that side.

Eric Swartz: You heard it here, folks. Good for America, good for tech. We love it. Thank you again, Pat, for joining us today. We really appreciate the insights and think that our listeners will love everything you had to say.

Pat White: It was absolutely my pleasure. Anytime you guys want me, I'll be back. This was really fun.

Leah Satlin: Thanks again, Pat. And for our listeners, before you go, if you enjoyed today's episode, please be sure to subscribe and hit the like button.

Kevin Iredell: Thank you for listening to today's episode. Please subscribe to our podcast series at lowenstein.com/podcasts, or find us on iTunes, Spotify, Pandora, Google podcasts, and SoundCloud. Lowenstein Sandler podcast series is presented by Lowenstein Sandler and cannot be copied or rebroadcast without consent. The information provided is intended for a general audience and is not legal advice or a substitute for the advice of counsel. Prior results do not guarantee a similar outcome. The content reflects the personal views and opinions of the participants. No attorney-client relationship is being created by this podcast and all rights are reserved.