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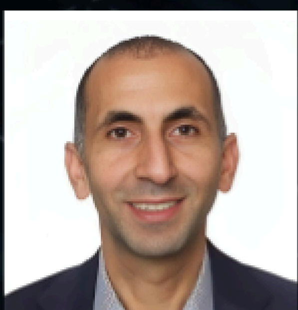
Virtual Event Series

Can Crypto Go Mainstream Without Robust Back Office Tools?

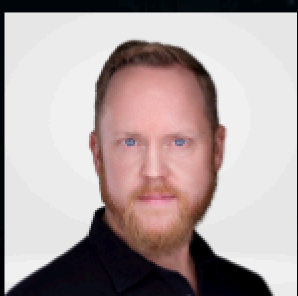
Guest Speakers:



Norman Hannawa
Tax & Accounting Solutions
NODE40

Perry Woodin
Chief Executive Officer
NODE40

Hosts:



Kenny Estes
CEO & Founder
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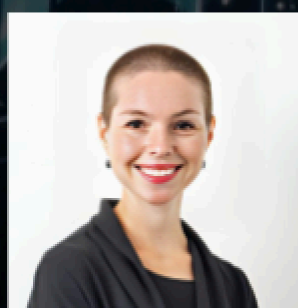

Ayla Kremb
COO & Co-Founder
Diffuse

DiffuseTap: Can Crypto Go Mainstream Without Robust Back Office Tools?

Last time on DiffuseTap, Perry Woodin and Norman Hannawa of NODE40 talked to us about some of the back-office tools that crypto lacks in comparison to TradFi, how the new crypto tax rules are putting an end to the wild west of crypto taxation, and how TradFi companies are going to leverage these new rules to consolidate with DeFi.

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DiffuseTap: Where Crypto and Technology Shape Finance

DiffuseTap takes you to the heart of finance and digital assets. See how changes in crypto and tech are transforming the industry, with insights from top leaders and experts.

Meet the Speakers

PERRY WOODIN is a leader in blockchain accounting and business development with 20+ years of experience managing and developing software applications and services. He is the CEO of NODE40, the digital asset reporting software for institutions that transact on- and off-chain.

Linkedin: @perry-woodin

NORMAN HANNAWA is a tax attorney who has had 20+ years of experience at several large law firms. Most recently, he was Director of Tax Strategy at blockchain analytics firm Chainalysis. He is currently the Head of Tax and Accounting Solutions at NODE40.

Linkedin: @norman-hannawa

About Diffuse

We are an alternative fund platform offering differentiated investment products. From digital assets, to VC funds, and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information visit www.diffusefunds.com.

KENNY ESTES: Over to our speakers, Norm and Perry. Thank you both for coming. Norm, do you want to start it off? Give a little bit of your background and what you are up to over at Node 40.

NORMAN HANNAWA: I'll let Perry start off here if you want to give the background, and then I can jump in.

PERRY WOODIN: Yeah, I'll give a little bit of background. Going back to meeting my co-founder, we were both engineers who met each other back in 2012. We got into blockchain early. In 2015, we started a staking company in the space, where customers were getting yield. At the end of 2015, our customers were asking us for financial reports so that they could understand what that yield is.

That was because a brand new asset had a different basis every time you get it. It was complicated. So, we built a financial engine to produce reports and fell in love with that. Today, what we really focus on is aggregating lots of digital asset data and then producing the reports that businesses need to understand what their position is, any strategy they can take, and any liabilities they may have.

That is really where Norm's level of expertise comes in. While we are a really technically heavy company, Norm can have that conversation around what it means for a company and what their needs are in the space.

NORMAN: Hey, everyone. I've been on DiffuseTap a while ago now. I got to know Kenny and Ayla, and now I have been with Node 40 for about a year and a half. My background is in tax and accounting. I was a tax partner at EY in their financial services group for about 10 years, doing large transactions for insurance companies, hedge funds, PE funds, etc.

Then I got into blockchain, specifically blockchain tax and accounting. I joined Node 40 about a year and a half ago, and fell in love with the company. I love the product and see so many use cases for it, particularly not just for tax but accounting, audit, financial planning, tax planning, etc.

KENNY: Okay. So, you are clearly sitting at the intersection of traditional finance, institutional reporting, and things like that, and crypto. The topic today is crypto tooling. What are the things that are lacking today in the crypto environment from what you would expect from a more traditional financial institution?

PERRY: Norman, I'll take that. Well, what was lacking up until July 9 of this year was final regs. The Treasury released final regs on how people need to be treating these digital assets that they have on their balance sheet. At a high level, what it really comes down to is lot relief, and how you are going to dispose of these assets or move them around. And then, the other is cost basis, and how you are going to calculate that.

So, the Treasury came out with what these regs are, and we now have a go-forward where everybody who is playing in this space needs to have their books and accounting in order by January 1 of 2025, so just a few months down the road.

That is what was missing. Norman, I'm happy to turn it over to you to talk about the specific needs that companies had and why it was difficult for them to meet those financial reporting needs.

NORMAN: I'll just start with a couple of verticals. As far as tax goes, whether it's hedge funds, traders, or exchanges engaging in massive volumes of transactions, we are having difficulty keeping track of all the data, processing it, and knowing exactly where they financially stood, preparing financial statements, tax reports, etc. That was one big hurdle.

Going to Perry's point, for a while, people were doing whatever they wanted, especially in the tax space. Those days are coming to an end, at least in the US and Europe, and more. Whether it's US GAAP, IFRS, OECD, all those rules are starting to be implemented to provide more detail on what exactly you have to do as a crypto investor, trader, exchange, custodian, whatever it might be.

You are going to need tools to process that type of data, make the decisions you need to make, etc. Outside of those areas, I talked earlier about audit. People need to be able to audit exactly what has been going on. Kenny knows about this a little bit with hedge funds and investment funds.

They have investors, and they need to be audited. Those are just one type of audit—public companies, etc. So, that's another area, in addition to the accounting and preparing the financial statements.

KENNY: Okay, that makes sense. You both touched on the July 9 clarity around these rules. Can you give a high-level overview of some of the key takeaways from that? Things the audience might not be aware of, or some of the high-level clarifications that were made.

PERRY: So, high level, Norm made reference to it no longer being the Wild West. People used to “form” transactions, meaning they were sending value somewhere else, and after the fact they would try to reconcile that.

What the regs say now is that prior to forming a transaction, prior to sending a digital asset somewhere that could have a capital impact, you need to have either a standing order as to what tax lots you are going to dispose of, what that lot relief methodology is.

KENNY: Sorry, what is a tax lot?

PERRY: A tax lot is, as you are acquiring assets, each asset has its own cost basis at the time you acquired it. Think about the way property works. Those are the rules applied to digital assets. When you acquire something, it could be worth $1 one day and $2 the next day. You have to track all of those so that when you move it, you can calculate the difference between the cost basis for that tax lot versus its value at the time of disposition. The difference is your liability.

KENNY: So is this like FIFO, LIFO type stuff?

PERRY: Right. There are a couple of ways to handle this. There's FIFO, which is the default that the Treasury says you can use, or there's Spec ID, which is preferred. Spec ID is specifically identifying the tax lots you want to dispose of or move. In Bitcoin, it's easy because they have UTXOs.

Every unspent transaction output can be its own tax lot, and you can individually pick these when you form a transaction. With account-based currencies like Ethereum, you have to select a methodology ahead of time. The default might be FIFO, but people are making the case for HIFO, or high in, first out. You would draw down on the highest value asset first. But again, those have to be defined with a standing order prior to the transaction.

KENNY: And the advantage of HIFO is to minimize capital gains, right? It's the highest price. So the idea is, when you sell it, assuming you're in the money, that will minimize your capital gains.

PERRY: Yes, correct.

KENNY: Okay, question from Ray. This sounds complicated. Does this ruling make it harder for the average consumer to use these currencies as currencies?

PERRY: Yes, it's very complicated because as a disruptive technology, it's brand new. Wrapping your head around what this thing is, is important. Many people got in, saw the potential to make money, and just went for it. Now we need to look at the strategy for interacting with digital assets.

To have a strategy, you need to be well-informed, capturing the data available on-chain, and tracking it to make decisions about how you'll interact with these assets. While it's complicated, it's all potentially programmatic.

My co-founder, Sean Ryan, has spent a lot of time understanding this new technology. The fact that it's all programmatic means you can develop tools like Node 40 to bring efficiencies to how you interact with digital assets.

NORMAN: I would just add, Kenny, as an example, you can take this one and multiply it by 50 more. Let's say you're on Coinbase. You bought a coin and transferred it to participate in an on-chain transaction, like DeFi lending or borrowing. The exchange, now under these rules, will report to the IRS. They are now required to report, potentially indicating you had a gain or loss on that transaction via a 1099. So, the IRS will now have reports indicating gains or losses.

You, as the taxpayer, have to prove if that report is incorrect. For instance, you brought something into Coinbase, and Coinbase says, "Hey, we don't know where it came from, but we are going to report to the IRS." You, the taxpayer, must prepare the reports and maybe even inform Coinbase about where you got that asset and how much you bought it for. There is going to be a lot more information provided to the government, and you, as the taxpayer, will need to defend your position going forward.

KENNY: Gotcha. I'm sure all the crypto purists are going to love that. This sounds not too dissimilar from 1099s and how they've always worked, where the exchanges report your trades. If you can file differently, that's fine, but you just need to support why you are not going with those numbers.

PERRY: The difference, Kenny, is that with traditional 1099s, there is a clearinghouse to determine the value of the asset. With digital assets, only the asset's owner, the custodian, knows the value of the asset. So, the burden falls on the individuals interacting with these assets. This might change over time, but for now, individuals will need tools to help figure that out.

KENNY: Okay, so back to Ray's point. If I wanted to buy a can of Coke, this seems overly complex compared to just using money, right? Given this rule set...

NORMAN: One thing to that point—the IRS doesn't want to be flooded. They recognize some of that, and have some de minimis exceptions for things like stablecoins. I don't want to get too deep. Ray and I could have a whole hour-and-a-half session on this, but the rules are pretty complex. There are 300 pages of rules, and that is just the starting point. More rules will come over the next few years, along with the OECD issuing rules. So, Ray, there are some potential opportunities to avoid some of this, but only for very small amounts.

KENNY: Okay, so this is generally part of a larger trend towards institutionalization of digital assets, right? Rules and regulations are just part of that, which obviously helps the incumbents more than anybody else. How do you see the interplay between this new financial services system and traditional ones? Will they combine, or will they always be separate paths?

PERRY: Well, traditional finance is going to eat it up. I think that is probably an unpopular opinion, especially for the crypto crowd. Prior to regulation, anybody could do anything, and they could just say, "Listen, there is nothing that says I can't do this."

Now that there is, now that there are finalized regs, you are going to see the traditional finance organizations, institutions, and businesses say, "I think we can leverage this to gain efficiencies, cut down on costs, and still offer investment vehicles that can live natively on the chain," and open that up to a much broader audience than than they ever could before.

They will model a lot of that off of the work that was done by some of these cowboys, and then even some of the folks that were just thinking, "I want to survive for the next couple of decades. And they did do this, but they are not traditional finance." Traditional finance will either buy that up or just copy it.

KENNY: Interesting. My background is in high-frequency trading, and institutions generally aren't great at innovating. They tend to buy solutions and integrate them into their systems. Are you suggesting they will do it in-house instead of through acquisitions?

PERRY: The beauty of some smart contracts already developed is that institutions, like Fidelity, wouldn't have to buy them. They can copy the protocol and tweak it as needed. They might buy the customer base of a well-known protocol doing things right, but if they see something interesting, they can copy the code base and deploy their own contract with their institution's requirements.

KENNY: Interesting. So that is effectively an IP issue. They can just fork it without reinventing the wheel. But then, what is the intrinsic value of these crypto enterprises if the code base can be forked so easily?

PERRY: The intrinsic value is probably going to be the customer base. Think about some of the larger players, like Uniswap who already have a large customer base. Granted, they don't know who some of those customers are. But if they KYC those customers, if they know who that customer is, that can become really valuable, because they have gone through the hoop of making sure that those customers can interact with the financial vehicles that they have developed, and they know who they are and that you can sell to them.

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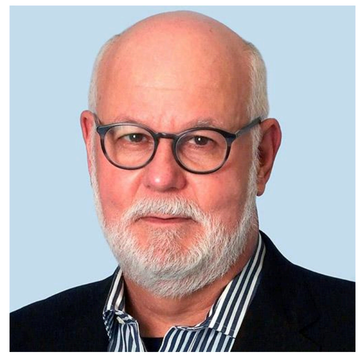

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