BLOCKCHAIN & ENTERTAINMENT

THE NEXT WAVE

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WHAT IS BLOCKCHAIN?

"Blockchain Technology" refers to cryptographically-secured, decentralized ledgers that are distributed among parties using the ledgers to transact within a common network.

Think of a giant, _secure_ spreadsheet accessible by anyone who wants to edit it, but only the next line of the sheet can be changed (no re-do's). And with rewards for good edits.

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WHY IS THIS A BIG DEAL?

- **Trustless –** Everyone is incentivized, by reward, to validate transactions; economically, they don't care *who* is transacting.

- **Cryptographically secure –** Unhackable(ish).

- **Chronological, timestamped, and immutable –** Once the transaction is recorded it cannot be undone.

- **Decentralized –** Has the potential to eliminate governments and banks.

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BITCOIN & BLOCKCHAIN: WHAT'S THE DIFFERENCE?

- **Blockchain is *not* Bitcoin. Bitcoin uses blockchain.**

    – **Bitcoin is the first (and now one of many) *uses* of the tech – it enables "trustless" peer-to-peer transactions with a verifiable degree of security.**

- **Bitcoin (2008) is a cryptocurrency, a "peer-to-peer electronic cash system."**

    – **Bitcoin is "distributed" *and* "decentralized."**

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BIG IDEA: VERIFIABLE AUTHENTICITY

- **Cryptographic hashing** and a **distributed network** enable you and everyone else in the network to confirm your "kitty" is one of one.

What is CryptoKitties?

CryptoKitties is a game centered around breedable, collectible, and oh-so-adorable creatures we call CryptoKitties! Each cat is one-of-a-kind and 100% owned by you; it cannot be replicated, taken away, or destroyed.

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BIG IDEA: DIGITAL SCARCITY

- **Either the network or the entity or entities responsible for the way the network makes decisions, limit the supply of your kitty and the replicability of its traits.**

But, unlike traditional collectibles, you can breed two CryptoKitties to create a brand-new, genetically unique offspring.
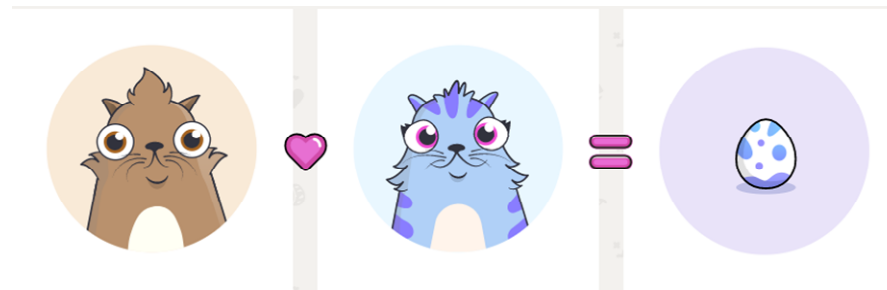
It results in something special—just like you!

Start meow

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BIG IDEA: SMART CONTRACTS

Smart Contracts are digital agreements between parties that transactions will execute *automatically* upon the happenings of specific, digitally-recorded events.

EXAMPLE: Artist leases "hosting rights" for Song to Stream Co. via Smart Contract: For the month of May, Stream Co. users will pay Artist directly (not Stream Co.) each time the user plays Song.

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SMART? CONTRACTS?

- **A very different way to solve problems**

- **Serious limitations**

- **Amazing new capabilities**

- **Not always smart**

- **Perhaps not always a legal "contract"**

qnimate.com/writing-upgradable-smart-contracts-in-ethereum/

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BIG IDEA: DYNAMIC PRICING

- **Dynamic Pricing = setting flexible prices for products or services so that the current market demand dictates the price**

- **Think of "surge pricing" in shared ride applications**

- **For an artist, immutable pricing and purchase records plus direct control over who has access to the artist's work provides opportunities for more accurate pricing of the work**

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USE CASES

Five key forces of blockchain technology can serve as a platform to protect artist rights.
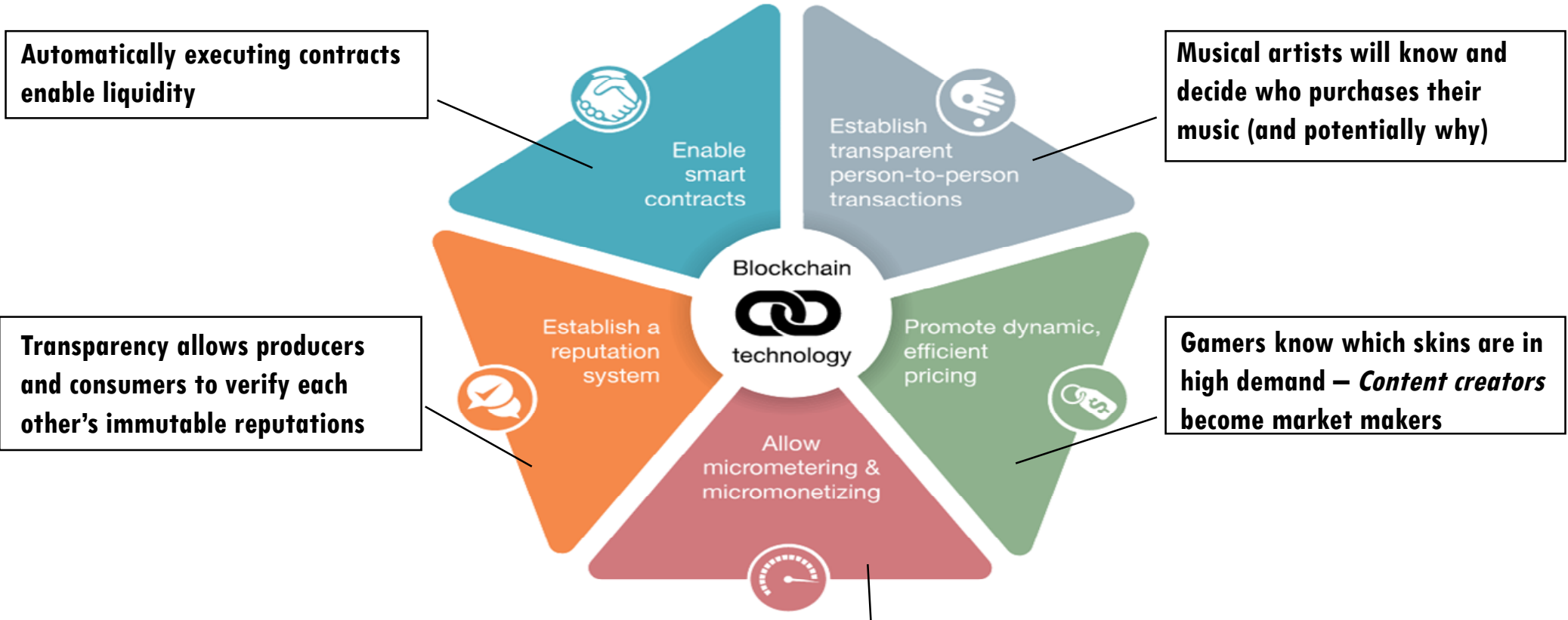
Automatically executing contracts enable liquidity

Musical artists will know and decide who purchases their music (and potentially why)

Transparency allows producers and consumers to verify each other's immutable reputations

Gamers know which skins are in high demand – *Content creators* **become market makers**

Enable smart contracts

Establish transparent person-to-person transactions

Blockchain technology

Promote dynamic, efficient pricing

Establish a reputation system

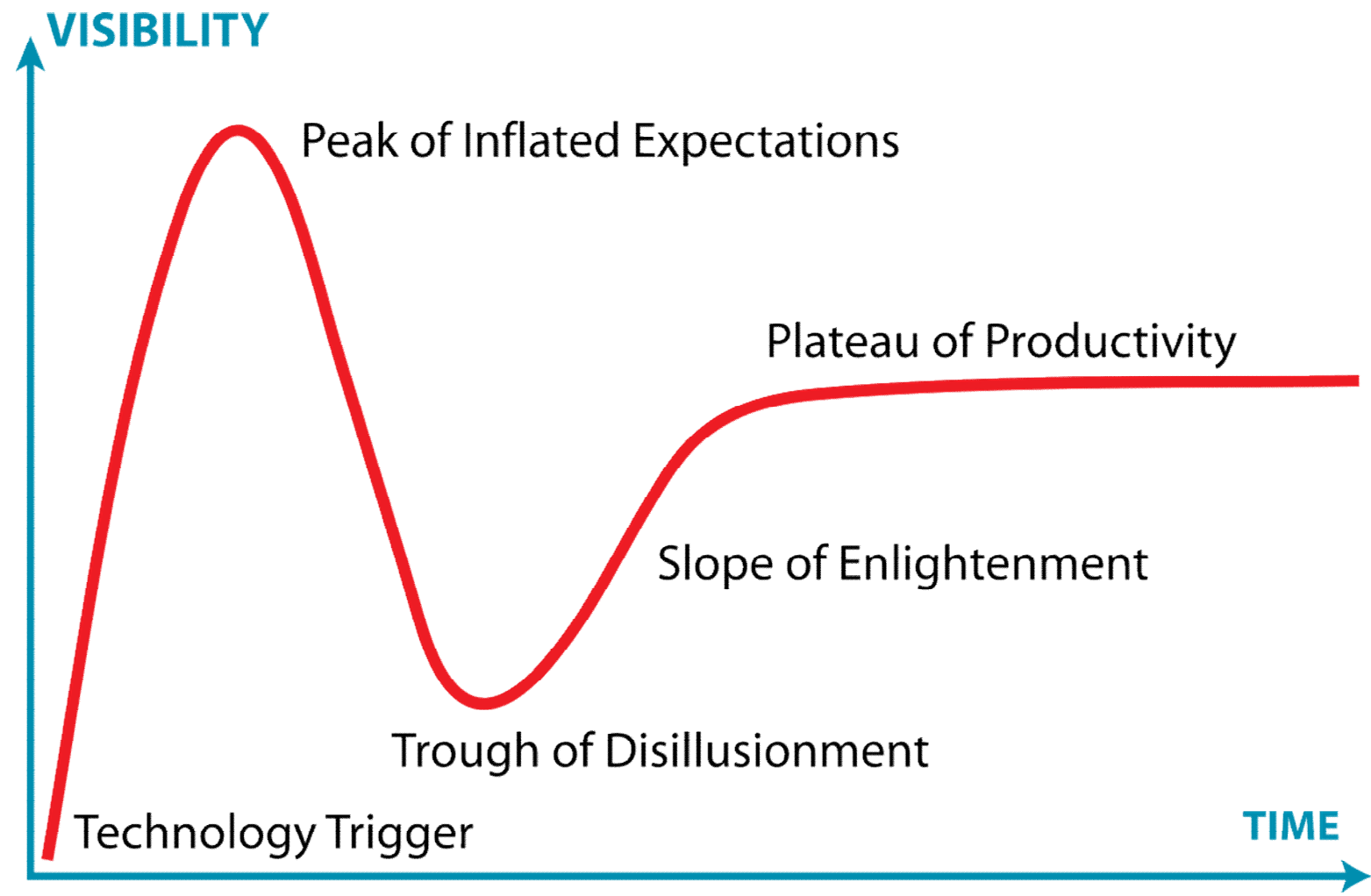Allow micrometering & micromonetizing

McKinsey&Company

Digital cash + Smart Contracts = Digital Gig Economy

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ENTERTAINMENT EXAMPLES

- **Ujo** – **Independent music distribution and payments**

- **Tao** – **Decentralized Autonomous Organization ("DAO") exchange for music rights (DAO votes on policies/standards by Smart Contract)**

- **Steem** – **Immutable written content (blog) on social media**

- **StreamSpace** – **Peer-to-peer video content host**

- **Splyt** – **Decentralized e-commerce powered by smart contracts**

- **MediaChain** – **Acquired by Spotify; "universal media library"**

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GARTNER HYPE CYCLE

VISIBILITY

Peak of Inflated Expectations

Plateau of Productivity

Slope of Enlightenment

Trough of Disillusionment

Technology Trigger

TIME

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CLOUDS LOOMING OVER THE BLOCKCHAIN SPACE

- **Absence of regulatory clarity in the U.S.**

- **Fraud is disproportionately prevalent**

- **Far too much indiscriminate funding of blockchain projects**

- **…BUT we are still believers in the long-term prospects of blockchain, and to a lesser extent, digital currencies.**

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BLOCKCHAIN REPORT: TAXATION

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NOTICE 2014-21

- **Provides directional guidance with respect to virtual currencies (e.g., bitcoin).**

- **Generally does not apply to Ethereum or other token-based blockchain systems.**

- **Virtual currency is treated as "property" and not "currency" for income tax purposes.**

- **Unclear what "type" of property (e.g., a security?).**

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CHARACTER

- **Purpose of holding "property" drives tax consequences**

  - **Dealers (e.g., inventory)**

  - **Investors (e.g., capital asset)**

  - **Manufacturers (e.g., QBI?)**

  - **Personal (e.g., losses)**

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GROSS INCOME

- **Recognize FMV as gross income upon receipt**

  - **Receipt for goods & services**

  - **Receipt by virtual currency miners**

- **Employment Taxes**

  - **Mining carried on as a trade or business and not an employee, net earnings subject to self-employment tax**
  - **Mining as an employee subject to income tax withholding and employment tax withholding**

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TAX BASIS

- "Property" has tax basis (cost), which ultimately measures gain or loss upon disposition

- Cost basis of a unit of cryptocurrency "received" as payment for goods/services is equal to the FMV of that unit in U.S. dollars on the date of receipt

- Benefits and burdens of ownership

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GAIN OR LOSS

- **Gain or loss is determined by FMV less tax basis upon sale/exchange**

- **If amount realized > basis = gain**

  - **Character depends on how property is held**

  - **Inventory = ordinary rates (miners / dealers)**

  - **Investment = capital gain**

- **If amount realized < basis = loss**

  - **Ordinary loss = fully usable (subject to new loss limitation rules)**

  - **Capital loss = fully usable against capital gain, limited against ordinary income**

  - **Personal loss = not deductible**

- **One virtual currency for another – IRC 1031 no longer available**

- **Is receipt of new currency in a fork event taxable?**

- **Currency rules have a de minimis rule – no such rule for virtual currencies**

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MINERS

- A "partnership" includes any group or joint venture through or by means of which any business, financial operation, or venture is carried on (generally with a sharing of profit and loss)

- Do pooled mining activities constitute a partnership for tax purposes?

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<u>REPORTING</u>

- **Special reporting rules / filings for security brokers (e.g., Form 1099-B used to report amounts of sales transactions)**

- **Enforcement**

  - **IRS Criminal Investigation division director has cautioned that activity "is not really anonymous, and we actually have suspicious activity reports being filed on these and we are able to trace them back to the inception of the bitcoin – every place it has touched."**

  - **IRS can issue summonses to virtual currency exchanges. Coinbase No. 17-cv-01431 (involving subpoena issued to bitcoin exchange Coinbase, seeking its customer and transaction records).**

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PENALTIES

- **Penalties may be imposed for failing to comply with tax laws**

- **No safe harbor or penalty relief for transactions or virtual currencies that occurred or were reported before 3/25/14 (the date Notice 2014-21 was released)**

- **Potentially subject to accuracy-related penalties (20% on underpayment)**

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QUESTIONS?

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