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Crypto Currency Update

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How can our government effectively enforce taxation of the use of crypto currency? Congress is trying with the Senate passed Infrastructure Bill provisions on crypto currency. The Senate's proposal requires businesses to report crypto currency transactions in excess of $10,000 to the IRS.[1] In addition, the Senate Bill expands the definition of brokers for purposes of the Internal Revenue Code's information reporting requirements to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[2] Furthermore, the Bill requires crypto currency exchanges to report transfers of digital assets from an exchange account to any another account to the IRS (under Section 6045A of the Code). The Bill delays implementation of these crypto compliance provisions, however, until the 2024 calendar year. In addition, the proposed digital exchange reporting provisions defer the specifics of such reporting to the Treasury Secretary.[3]

The proposed tax legislation is a reaction to the increasing use of crypto currency to evade taxes. The Department of Treasury in its General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals notes that tax evasion using crypto assets is a rapidly growing problem. "The global nature of the crypto market offers opportunities for U.S. taxpayers to conceal assets and taxable income by using offshore crypto exchanges and wallet providers."[4] In addition, in testimony before the Senate Finance Committee in April 2021, IRS Commissioner Charles Rettig stated the U.S. fails to collect as much as $1 trillion in taxes owed each year in part due to the explosion in cryptocurrencies, difficult for the IRS to track and tax.[5]

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The Congressional House of Representatives supports additional funding for the IRS to help with crypto currency tax enforcement. In H.R.4345, the Financial Services and General Government Appropriations Bill for 2022, which the House introduced on July 1, 2021, the House Financial Services Committee recommended $13,156,926,000 in discretionary IRS funding for fiscal year 2022, a 10.4% increase above fiscal year 2021. The Committee recommended an additional $416,897,000 in funding to increase IRS enforcement and operations support.

To understand how the IRS can effectively enforce taxation of crypto currency transactions, it is helpful to understand the history of crypto currency. The idea of crypto currency first developed as a method of electronic payment for transactions without the use of financial institutions or the government mint as intermediaries. In a paper written by Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System," Mr. Nakamoto stated that he desired to use a crypto currency "to avoid the transaction costs imposed in relying on financial institutions to process electronic payments." Mr. Nakamoto wrote that such a trust based model increases transaction costs because, "completely non-reversible transactions are not really possible, since financial institutions cannot avoid mediating disputes."[6] With such a system, "merchants must be wary of their customers, hassling them for more information than they would otherwise need. A certain percentage of fraud is accepted as unavoidable."[7] He notes that these costs and payment uncertainties can be avoided in person by using physical currency, but argued that no mechanism exists to make payments over a communications channel without a trusted party.

Mr. Nakamoto suggested an electronic payment system based on cryptographic proof instead of trust, allowing two willing parties to transact directly with each other without the need for a trusted third party. He suggested "transactions that are computationally impractical to reverse would protect sellers from fraud, and routine escrow mechanisms could be implemented to protect buyers."[8] Therefore, Mr. Nakamoto suggests using computer programming to avoid the use of financial institutions and government mints in payment transactions. The Coinbase website adds in addition that no company, country, or third party is in control of the crypto currency; and anyone can become part of the crypto currency network.[9]

Mr. Nakamoto defines an electronic coin as a chain of digital signatures. Each owner transfers the coin to the next owner by digitally signing a "hash" of both the previous transaction and the public key of the next owner and adding these digital signatures to the end of the coin. A payee can verify the signatures to verify the chain of ownership. This chain of ownership of the digital currency is often referred to as a "blockchain." The Coinbase website provides another analogy to the ownership chain: "A cryptocurrency blockchain is similar to a bank's balance sheet or ledger. Each currency has its own blockchain, which is an ongoing, constantly re-verified record of every single transaction ever made using that currency."[10]

Mr. Nakamoto proposed anonymity in the crypto currency transactions to maintain privacy for the transactors. He writes that the traditional banking model achieves a level of privacy by limiting access to information to the parties involved and the trusted third party.[11] Mr. Nakamoto notes that the necessity to announce all transactions publicly with crypto currency transactions precludes this method, but privacy can still be maintained by keeping public keys anonymous. In other words, the public can see that someone is sending an amount to someone else, but not the personal information of the transactors. He writes that this format is similar to the level of information released by stock exchanges, where the time and size of individual trades is made public, not the parties to the trades.[12]

Mr. Nakamoto envisioned the use of crypto currency as a method to conduct business transactions. However, the rise of crypto currency within the United States thus far has been less in the world of legitimate business transactions and more in the world of trade speculation and illegal transactions.[13] Perhaps this use is a testament to the fact that the world of trust, with all its transaction costs, provides a different benefit to users: simplicity. The mathematical complexity of crypto currency and need for significant computer energy do not help to facilitate its widespread commercial use. In fact El Savador's latest experiment in using bitcoin as its national currency shows the challenges of avoiding a trust based system for financial transactions.[14]

The IRS has had success in its recent enforcement campaign against crypto currency investors and traders who evade income taxes on currency gains. In 2016, the IRS was able to compel Coinbase, a large digital currency exchange, to turn over customer information on crypto currency trades. Because of its litigation success, the IRS wrote notices to 10,000 taxpayers regarding their crypto currency tax reporting and as a result:

- received more than 1,000 amended tax returns;
- collected $13 million in taxes from crypto holders with more than $20,000 of transactions; and
- collected another $12 million from other crypto notices.[15]

In April 2021, a Boston federal judge approved an IRS summons to Circle and its affiliates to turn over customer records of crypto currency trades. In May 2021, a federal judge in San Francisco approved another IRS summons for customer records to the Kraken crypto exchange.

The IRS has issued guidance outlining how general federal tax principles apply to transactions using virtual currencies.[16] For federal tax purposes, virtual currency is treated as property, not foreign currency. Therefore, if a taxpayer uses virtual currency to pay for other property in a business transaction (such as paying for business supplies), the taxpayer must treat the transfer of virtual currency to pay for the supplies as a sale of property (recognizing gain or loss on the currency's change in value). The type of gain (or loss) will depend on whether the virtual currency is a capital asset in the hands of the taxpayer. For many taxpayers, virtual currency will be a capital asset and any resulting gains or losses will be capital and either short or long-term using federal tax principles.

In IRS Revenue Ruling 2019-24, the IRS ruled that any taxpayer that receives new units of crypto currency as a result of an air drop following a "hard fork" of the crypto currency will recognize ordinary income on the new currency's receipt. This income recognition occurs whether or not the taxpayer disposes of the air dropped currency after receipt.

Because crypto currency is treated as property rather than as a stock or security, certain technical provisions of the Internal Revenue Code, such as the wash-sale rules of section 1091 do not apply. For example, if a taxpayer buys bitcoin, sells it at a loss, and repurchases it one day later, the taxpayer can offset losses from the previous crypto investment against future gain. This tax treatment contrasts from the treatment of sales of stocks and securities. Under section 1091 of the Code, if a taxpayer sells an investment in stock or securities for a capital loss, and the taxpayer repurchases the same stock or security, he or she cannot offset his past capital loss against future capital gain unless the taxpayer waits 30 days before repurchasing the same stock or security.

The IRS would do well to mitigate the use of crypto currency in the speculative trade by requiring all crypto markets, where individuals buy and sell crypto currency, to be treated as brokerage firms. Such crypto markets must report not only the gross proceeds in a crypto currency transaction but also the taxpayers' basis in U.S. dollars. The crypto markets must also be required to verify the identity of purchasers and sellers of crypto currencies as banks and brokerage firms must. This reporting by crypto markets should help other government divisions clamp down on the use of crypto currency for illegal transactions. After all, Al Capone was brought down for tax evasion. Mr. Nakamoto envisioned a world free of government intervention and trust with his crypto currency proposal. Such a world leads to instability. Tax reporting of crypto transactions and the mitigation of its illegal and speculative use is necessary to preserve the stability of our economy.

Notes

1. Section 80603(b)(3) of H.R. 3684, "Information reporting For Brokers and Digital Assets" 117th Congress (2021–2023) passed in the Senate on August 10, 2021.
2. Section 80603(a)(3) of H.R. 3684.
3. IRC Section 6045(a).
4. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Propoposals,: available online at *https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals*, at 94.
5. *https://www.cnbc.com/2021/04/14/irs-is-probing-the-dark-web-to-look-for-cryptocurrency-nft-tax-evasion.html* and *https://www.finance.senate.gov/hearings/the-2021-filing-season-and-21st-century-irs*.
6. Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System" at 1, available at *https://bitcoin.org/bitcoin.pdf*.
7. *Id*.
8. *Id*.
9. *https://www.coinbase.com/learn/crypto-basics/what-is-bitcoin*.
10. *https://www.coinbase.com/learn/crypto-basics/what-is-bitcoin*.
11. Nakamoto at 6.
12. *Id*.
13. *See, e.g.,* Nathaniel Popper, "Bitcoin Has Lost Steam. But Criminals Still Love It," NYTimes, Jan. 28, 2020, *U.S. Treasury Calls For Stricter Cryptocurrency Compliance With IRS, May 20, 2021, CNBC. https://www.cnbc.com/2021/05/20/us-treasury-calls-for-stricter-cryptocurrency-compliance-with-irs.html*.
14. *See* Charles Riley, El Salvador's bitcoin experiment is a warning to other countries, CNN Business, September 8, 2021. Updated 7:42 AM ET, Wed September 8, 2021
15. Laura Saunders, "The IRS Is Coming for Crypto Investors Who Haven't Paid Their Taxes," WSJ, May 14, 2021.
16. IRS Notice 2014-21.