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Federal Tax ADVISORY ■

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Crypto Asset Industry Cautious as Biden Administration Proposes New Reporting Rules

Over the past several months, investors and their advisers have closely monitored the Biden Administration's proposals to expand information reporting requirements for cryptocurrencies and other crypto assets. Based on the Department of the Treasury's General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals, released in May 2021 (commonly referred to as the "Green Book"), the Administration believes such expanded reporting requirements would combat "a rapidly growing problem" of tax evasion using crypto assets. The Administration's current proposal would require a broker to report information to the IRS for crypto assets held in its customers' accounts, including information about passive entities and their substantial foreign owners. The reporting requirements are intended to apply in a manner similar to the current Form 1099-B requirements applicable to broker and barter exchange transactions. The Green Book also proposes reporting requirements when businesses receive crypto assets in transactions with a fair market value of more than $10,000 and for transactions where crypto assets are transferred from one broker account to another. The Administration hopes to benefit from a global automatic exchange of information framework for crypto assets and seeks a mechanism for collecting and sharing this information with partner jurisdictions. However, despite its potential tax administrative benefits, the proposal has both supporters and detractors. Recently, the House Ways and Means Committee has proposed subjecting "digital assets," including cryptocurrencies, to the wash sale rules under Section 1091 and the constructive sale rules under Section 1259, injecting further uncertainty into the future taxation of crypto assets.

Proposed Amendments to Section 6045

Crypto asset reporting is currently a part of the bipartisan infrastructure bill before Congress. The infrastructure bill seeks to expand Section 6045 of the Code to more clearly apply to certain crypto service providers and to potentially apply to a broader portion of the crypto industry. Section 6045 and the Treasury Regulations issued thereunder currently require every person doing business as a broker to file returns containing the name and address of each of its customers, their gross proceeds on applicable transactions, and certain other information. Section 6045(c)(1) defines a "broker" to include a dealer, a barter exchange, and "any other person who (for a consideration) regularly acts as a middleman with respect to property or services."

The infrastructure bill would expand Section 6045 to treat as a "broker" subject to certain information reporting requirements "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." The proposed changes to Section 6045 would define a "digital asset" as, "[e]xcept as otherwise provided by the Secretary … any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary." Separately, the infrastructure bill would amend Section 6045A to require reporting when crypto assets are transferred from one broker account to another and also when crypto assets are transferred to a non-broker. In addition, the infrastructure bill treats digital assets as cash for purposes of Section 6050I, which requires any person engaged in a trade or business to file an information return relating to a transaction (or multiple related transactions) where they receive over $10,000 in cash in the course of such trade or business.

Policy Disagreements Concerning Reporting Requirements

The Joint Committee on Taxation estimates the infrastructure bill's proposed crypto reporting requirements would raise over $28 billion over 10 years. Supporters of these requirements point to this fiscal benefit estimate and concerns of widespread tax evasion in the crypto industry as reasons to support the proposal. Opponents of the proposal argue it is too broad and unclear and risks pushing digital asset business activity outside the United States. Some of these opponents are not opposed to additional reporting requirements entirely, but fear the definition of "broker" used in the infrastructure bill may apply to many parties, such as cryptocurrency "miners" and "stakers," which do not resemble traditional brokers.

Current Status of Crypto Asset Taxation

There is limited guidance on the federal income taxation of crypto assets. In Notice 2014-21, the IRS listed a series of frequently asked questions. Most importantly, the Notice announced the IRS's view that convertible cryptocurrency is a form of property for federal income tax purposes. In addition to Notice 2014-21, and subsequent expansions to the Notice with additional FAQs maintained on the IRS's website, the IRS has issued Rev. Rul. 2019-24, CCA 202035011, CCA 202114020, and CCA 202124008, each of which primarily addresses specific cryptocurrency transactions, leaving many unanswered questions and uncertainty about their application more generally.

The precedential value of the Notices, FAQs, revenue rulings, and chief counsel advice varies. They are not definitive statements of law, and in many cases tax practitioners may disagree with the IRS's interpretation. Further, the dearth of administrative guidance and court decisions concerning the tax treatment of crypto assets makes it difficult to gauge the true extent of crypto asset tax compliance issues. Increased reporting may well bring more tax controversies in the crypto space to light, but it is not certain the government's positions on the federal income tax treatment of crypto assets will prevail.

The Status of Mining and Staking Activities as an Example

Whether the proposed reporting requirements will apply to cryptocurrency miners and stakers remains subject to debate. Mining and staking are two methods for increasing the ability to record transactions in a particular cryptocurrency and often result in the miner or staker being rewarded new cryptocurrency either in the form of newly generated cryptocurrency or user fees. In order to accomplish this goal, miners use computer power to solve complex equations, whereas stakers invest units of cryptocurrency as a form of guarantee for transactions. Notice 2014-21 states the IRS's position that, for a taxpayer who successfully mines virtual currency, the fair market value of the virtual currency as of the date of the taxpayer's receipt is includible in its gross income. In other words, the IRS's position is that a cryptocurrency miner recognizes taxable income when awarded with additional units of the cryptocurrency. The Notice's application to staking activities is unclear. However, even when limited to mining, this position contains layers of complexity. For instance, for federal income tax purposes: How much mining must one do to be considered to be engaged in a U.S. trade or business? Can mining cryptocurrency and then selling it result in one being treated as a "dealer"? When are these tax determinations required to be made? These types of questions are particularly important for non-U.S. or tax-exempt investors who may be interested in investing in cryptocurrency assets, and a lack of clear guidance on reporting requirements compounds these uncertainties.

Conclusion

Uncertainties surrounding the appropriate federal income tax classification of numerous crypto asset transactions should be a part of any tax policy discussions about additional tax reporting requirements for the crypto industry because this uncertainty combined with increased reporting requirements could encourage investors and providers to pursue their crypto activities in non-U.S. jurisdictions.

Notably, current proposals would grant extensive discretion to the Treasury Department in excluding items from the definition of "digital assets," developing forms for reporting, and determining precisely what information must be reported to governmental authorities. Seemingly small technical distinctions in these rules could significantly affect the federal income taxation of different cryptocurrencies and digital assets. Ideally, Congress and the Treasury Department will develop tax reporting requirements that both address tax policy concerns and are practically feasible from an industry perspective.

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