CRYPTOCURRENCY

The New Frontier of Taxation and Enforcement

By Joshua D. Smelter

A lot of discussion has occurred regarding the changes caused by the global pandemic. Many people tend to compare pre-pandemic situations to current situations. One of the many things that has experienced dramatic changes during the course of the pandemic is cryptocurrency. Bitcoin's value, arguably the most popular cryptocurrency, rose dramatically from around $5,000 in March 2020 to a high of around $63,000 a year later.

The use of blockchain technology has increased as well, which has caused a value increase in other cryptocurrencies that facilitate applications like smart contracts (e.g., Ethereum). Popular payment services like PayPal now allow users to buy and pay with cryptocurrency, and there are now thousands of ATMs allowing the buying and selling of cryptocurrency.

None of this is, necessarily, pandemic related. However, it is clear that the mainstream use, viability and legitimacy of cryptocurrency has increased dramatically.

All of these changes in the use and acceptability of cryptocurrency have also sparked an increase in creative uses of the blockchain technology and its related cryptocurrencies. Digital assets called Non-Fungible Tokens (NFTs) representing real-world objects such as art, music, sports memorabilia and videos have seen huge increases in use and value.

You can collect and "breed" your own designer CryptoKitties or purchase a digitally created punk portrait using blockchain technology. Beyond collectibles, these NFTs could be used for other financial transactions that rely on ensuring a chain of ownership (e.g., real estate title reports).

Cryptocurrency is also showing up in more traditional financial products, and there are now retirement plans catering to cryptocurrency investment and cryptocurrency backed loans. Meanwhile, both individuals and businesses are supporting the blockchain through mining operations that earn cryptocurrency in return for the computing and validation services provided.

Anytime there are transactions involving assets having value, there are usually tax consequences. As cryptocurrency innovators and investors continue to make, market and profit from the new technology, regulators are trying to keep up. Many government agencies, most prominently the Internal Revenue Service (IRS), have publicly made cryptocurrency enforcement a top priority.[1]

This article focuses on the enforcement efforts of the IRS, and the reporting, compliance and legal issues currently facing cryptocurrency.

The Current Status of Cryptocurrency Taxation

The first formal guidance issued by the IRS for cryptocurrency occurred in 2014, defining virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value."[2] The notice further stated that, for federal tax purposes, "virtual currency is treated as property" and that "tax principles applicable to

property transactions apply to transactions using virtual currency."[3]

Therefore, when a taxpayer receives, sells or exchanges virtual currency, they have gain or loss and, in the hands of the taxpayer, the virtual currency is a capital asset.[4] A taxpayer who "mines" cryptocurrency must include the fair market value of the virtual currency in gross income as of the date of receipt.[5]

Also, there are information reporting requirements for anyone who, in the course of their trade or business, makes a payment using virtual currency with a value of $600 or more.[6] Several other issues related to items like backup withholding and self-employment income are also covered by the 2014 guidance.[7]

Since the 2014 guidance, the IRS has issued additional guidance through the form of FAQs on its website.[8] Although helpful, FAQs do not have the force of law and can be removed by the IRS without warning. If relying on a specific FAQ, it is good practice to print it in hard copy in case the IRS decides to remove it at a later date.

The next formal guidance from the IRS arrived in 2019 in the form of a Revenue Ruling on the treatment of "hard forks" and "air drops."[9] Hard forks occur when there is a protocol change on the distributed ledger that may create a new cryptocurrency. An air drop is a distribution of cryptocurrency units to addresses on the legacy distributed ledger.

The Revenue Ruling essentially says that a taxpayer has ordinary income if, as a result of a hard fork or air drop, the taxpayer receives units of new cryptocurrency.[10]

Beyond the limited formal guidance and informal FAQs, taxpayers and their advisors have attempted to rely on the regular tax principles related to property under the Internal Revenue Code (IRC). For example, cryptocurrency collectibles are not specifically mentioned in the formal or informal guidance.

Unlike other investments, the IRS does not treat collectible assets very favorably. The tax rate on most net capital gain is no higher than 15% for most individuals. Some or all net capital gain may be taxed at 0% if taxable income is less than $80,000. However, in the case of collectibles and some other types of gain, the maximum rate is 28%.

For taxpayers in higher income tax rate brackets, this may still be a lower tax rate, but not necessarily. Individuals with significant investment income may also be subject to the Net Investment Income Tax (NIIT).

Also, the IRS guidance on "mining" cryptocurrency was written when the process involved a Proof of Work (PoW) model and recent cryptocurrencies have adopted a Proof of Stake

(PoS) model as an alternative. Proof of Work involves the solving of complicated math problems in exchange for cryptocurrency rewards. This process requires a lot of computing hardware and power.

Proof of Stake, on the other hand, rewards users who "stake" their cryptocurrency and an algorithm decides on rewards based on the cryptocurrency staked on the system. This process involves much less hardware and power. A recent case, filed in the Federal District Court for the Middle District of Tennessee, is challenging the IRS claims that receipt of cryptocurrency under the PoS model is income when it is received.[11] Instead, the taxpayers claim that it is created property that shouldn't be taxed as income until sold.

As more potential ambiguities arise, the likely result is more courts weighing in on how cryptocurrency assets fit into the Internal Revenue Code's existing provisions and the established precedent on those provisions.

Taxpayers have limited options for seeking advice on proper treatment of truly novel applications of cryptocurrency transactions prior to reporting them on their tax returns. One option is a formal tax opinion discussing the legal nuances, factual details, and applicable authorities and arguments.

However, tax opinions are governed by guidelines set by the IRS, Treasury and the community of tax professionals, and relies heavily on authority for a position. The current lack of clear authority makes the rendering of a tax opinion with any amount of clarity very difficult.

Another option is a Private Letter Ruling (PLR) where a taxpayer requests a specific ruling for their situation from the IRS. However, this process is both expensive and discretionary on the part of the IRS (i.e., they may not issue a ruling just because you requested it).

Selling your firm is complex.

Let us make it simple.

- Confidentiality
- Maximizing Firm Value
- Negotiations
- Closing
- Transition
- Financing

Learn more and get a FREE Market Analysis at
www.AccountingBizBrokers.com

Office: 866-260-2793
Kathy: 501-514-4928
Christy: 501-499-4357

kathy@accountingbizbrokers.com*
christy@accountingbizbrokers.com
*member of the Texas Society of CPAs

TXCPA's Spring 2022 Conferences

Mark your calendar now and plan to attend TXCPA's spring conferences in May!

Technology Conference
May 5-6 | Webcast Only

Energy Conference
May 16-17 | Webcast Only
See event details

Texas School Districts Accounting and Auditing Conference
May 19-20 | Sheraton Austin Hotel at the Capitol
In person event details | **Webcast option**

Nonprofit Organizations Conference
May 23-24 | Irving Convention Center
In person event details | **Webcast option**

Free CPE for Members

Texas Taxes Quarterly
One-hour Webcast
January 13

Professional Issues Update Webcast
CPE Hours: 2
February 23

TXCPA Passport
The Passport offers a one-year subscription with unlimited access to more than 100 CPE hours and a variety of topics. Cost: Members $199 | Nonmembers: $329

View the complete schedule and register now in the Education area of our website at tx.cpa/education/cpe or call the TXCPA staff at 800-428-0272 (972-687-8500 in Dallas) for assistance.

This puts taxpayers in a difficult position when the answers are not clear.

The IRS Focus on Reporting Cryptocurrency Transactions

According to guidance from the IRS, all income, gain or loss involving virtual currency must be reported regardless of the amount or if you received a form W-2 or 1099. Because cryptocurrency is treated as property (like stocks or real estate), taxpayers pay taxes if they realize a gain, but may be able to claim losses when they realize them. As property, taxpayers must know:

- When they bought the cryptocurrency;
- How much they paid; and
- What they received for it.

This can sometimes be difficult if the purchase was outside of an established exchange or inherited without clear documentation. Also, because cryptocurrency is treated as property, every exchange can trigger gain or loss. This makes small every-day purchases cumbersome to report.

However, as services like PayPal allow for broader use of purchases with cryptocurrency, this tracking for tax reporting may become easier. Also, a wide array of software exists for heavily trading cryptocurrency investors to use to report their gains and losses.

For those who have not, or are not, reporting their cryptocurrency, the IRS has clearly made finding them a top priority. In 2016, a federal court authorized the IRS to serve a John Doe Summons on Coinbase Inc. for information on U.S. taxpayers conducting transactions in virtual currency during the years 2013 through 2015.

The result was the release of 13,000 names of Coinbase customers transacting in cryptocurrency. What followed, in August of 2019, were 10,000 letters to taxpayers indicating that the IRS had information on their cryptocurrency transactions and knew that they either were not reported or reported incorrectly.[12]

The IRS used the John Doe Summons power again, in 2021, to serve John Doe Summonses on Circle Internet Financial Inc.[13] and Payward Ventures Inc. (i.e., Kraken)[14] which also deal in cryptocurrency.

Although the federal district court approved a revised version of the original summons for Kraken, it also explicitly indicated that it welcomed Kraken or its customers to file a challenge and it would be heard. This action by the court could be the result of a change in the John Doe Summons law, instituted by the Taxpayer First Act, requiring that a John Doe summons to be "narrowly tailored to information that pertains to the failure (or potential failure)" to comply with the Internal Revenue Code.[15] Regardless, even narrowed summonses will provide data the IRS can use to find taxpayers who do not report their cryptocurrency transactions

The Department of Justice and the IRS also recently started an investigation into one of the world's largest cryptocurrency exchanges, Binance, for potential money laundering and tax offenses.[16] This investigation will create more data for the IRS to track down cryptocurrency investors attempting to hide their holdings.

In addition to affirmative summonses and investigations of cryptocurrency institutions, the IRS is seeking legislation that would require disclosure of certain information by these same institutions without the need of court intervention. On Nov. 15, 2021, the *Infrastructure Investment and Jobs Act* was signed into law by President Joe Biden[17] that added provisions to expand the definition of "broker" and definition of "digital assets" to apply the cost-basis reporting regime for securities to digital assets.

The best way to avoid penalties is to disclose and report as accurately as you can, showing that you did not have a willful intent to avoid paying taxes.

Taxpayers may think that the IRS may penalize them, but they might assume that they need not worry about any criminal implications. Unfortunately, this is not true. The IRS, as part of its crackdown on cryptocurrency, is increasing its criminal investigations.

> ***"...in this world, nothing is certain except death and taxes."*** **— Benjamin Franklin**

Future Tax Controversies for Cryptocurrency

Lack of reporting will likely be the primary focus of IRS enforcement efforts for the near future. The IRS knows that the amount of unreported cryptocurrency is very large and is, most likely, the biggest enforcement issue. However, because cryptocurrency is a new asset, being used in new ways, other issues are bound to arise.

As discussed above, the IRS has stated that virtual currency is property and that the tax principles related to property apply. However, where cryp-

tocurrency doesn't fit neatly into the law established for other property, then disputes will inevitably arise. Recent IRS guidance on like-kind exchanges under Section 1031 of the Internal Revenue Code provides a good example.

Section 1031 has been in the Internal Revenue Code for a very long time. Section 1031 provides that no gain or loss is recognized on the exchange of property held for use in a trade or business, or for investment, if the property is exchanged for property of like-kind for use in a trade or business or for investment.[18] The regulations define "like-kind" as the nature or character of the property and not the grade or quality.[19]

The *Tax Cuts and Jobs Act* (TCJA) limited like-kind exchanges to real property after December 31, 2017. However, before the TCJA, taxpayers could use the like-kind exchange rules to exchanges of personal property, as well.

Although Section 1031 does not apply to trades of stocks and bonds, cryptocurrency isn't exactly like stock and bonds. Also, there is enough similarity between types of cryptocurrency that the applicability of the like-kind exchange rules was at least arguable.

It is unknown how many like-kind exchanges for cryptocurrency were done by taxpayers. However, IRS Chief Counsel saw a need to issue an advice memorandum on whether Section 1031 applied to exchanges of Bitcoin (BTC) for Ether (ETH), BTC for Litecoin (LTC), and ETH for LTC.[20]

The IRS indicated that BTC and ETH "held a special position" within the cryptocurrency market because most markets required an investor to purchase BTC or ETH first before purchasing other cryptocurrencies.[21] Essentially, according to the IRS, BTC and ETH "acted as an on and off-ramp for investments and transactions in other cryptocurrencies."[22] As such, the IRS determined that BTC and ETH "differed in both nature and character" from LTC and Section 1031 did not apply.[23]

Given the IRS lumping BTC and ETH together as holding a "special position," a person might think that at least they would qualify for a like-kind exchange, but not according to the IRS. The IRS acknowledges that BTC and ETH "share similar qualities and uses" and both are "used to make payments," but then decides that they are "fundamentally different."[24] The apparent "fundamental" difference is that ETH is a "platform for operating smart contracts and other applications" and BTC is not.[25]

A taxpayer in 2017 may not have recognized the "fundamental" differences and applied for like-kind exchange treatment only to find out years later that the IRS considered the position unjustified.

As the IRS issues more guidance, likely years later after reviewing reporting positions, more disputes will arise and taxpayers will need to decipher how to amend previous reporting positions.

Tax Implications and the Proper Treatment of Transactions

Cryptocurrency and blockchain technology will continue to develop and change at a rapid pace and regulators will probably always struggle to keep up with those changes. Although the primary focus of the IRS is currently on a lack of reporting, other issues are making their way through the audit process and the courts.

Taxpayers and their advisors must consider their own facts, current tax law principles and all available guidance at the time to determine the proper treatment of their own transactions. If there is a failure to

OPERATION Hidden Treasure

The IRS recently announced a program they called "Operation Hidden Treasure" that is using agents trained in cryptocurrency tracking specifically focused on taxpayers omitting cryptocurrency income. If convicted of tax evasion, taxpayers could face up to five years in prison and a fine as high as $250,000. The IRS has made willful failures easier for them to prove by moving the question about cryptocurrency transactions to the front of the individual tax return (Form 1040) so that it is as conspicuous as possible.

If a taxpayer has significant unreported cryptocurrency holdings, a voluntary disclosure is a good option. Criminal exposure can be limited by following the required steps and, in some cases, a streamlined voluntary disclosure might be warranted and comes with less severe penalties.

The IRS has specifically said that it does not plan to set up a specific disclosure program for cryptocurrency, but the standard voluntary disclosure program is still available. As the IRS and the Department of Justice investigate and obtain more data, it isn't a question of if, but when, they will find unreported cryptocurrency.

report or guidance that calls a previous tax position into question, taxpayers and advisors must determine how to amend and adapt their thinking on the tax implications in this new frontier.

About the Author:

Joshua D. Smelter is a tax litigator at Gray Reed and a former Department of Justice, Tax Division Honors attorney. He can be contacted at jsmeltzer@grayreed.com.

Footnotes

[1] IRS Notice 2014-21.
[2] IRS Notice 2014-21.
[3] IRS Notice 2014-21.
[4] IRS Notice 2014-21.
[5] IRS Notice 2014-21.
[6] See IRS Notice 2014-21.
[7] See https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.
[8] Rev. Rul. 2019-24.
[9] Rev. Rul. 2019-24.
[10] See *Jarrett v. United States*, Civil Case No. 3:21-cv-00419 (USDC M.D. Tenn.).
[11] See https://www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts.

[12] https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-0.

[13] https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1.

[14] 26 U.S.C. §7609(f).

[15] https://www.reuters.com/technology/binance-under-investigation-by-justice-department-irs-bloomberg-news-2021-05-13/.

[16] H.R. 3684.
[17] 26 U.S.C. §1031(a)(1).
[18] See Treas. Reg. §1.1031(a)-1(b).
[19 - 24] See CCA 202124008 (June 18, 2021).

AICPA Credentials

Many CPAs are leveraging the rapid growth of advisory services. AICPA offers exclusive credentials for qualified financial professionals that can differentiate you as having knowledge and expertise in a specialty practice area, giving you, your firm or your organization a competitive advantage. Credentials include:

Certified in Financial Forensics (CFF®)
Personal Financial Specialist (PFS™)
Accredited in Business Valuation (ABV®)
Certified Information Technology Professional (CITP®)
Certified in Entity and Intangible Valuations (CEIVTM)

For more information on how you can become a credential holder and boost your career, visit AICPA's website at www.aicpa.org/membership/join/credentials.html.

CGMA® Designation – For Management Accountants

The Chartered Global Management Accountant (CGMA®) is the most widely held management accounting designation in the world. It was established by AICPA and CIMA to recognize a unique group of management accountants who have reached the highest benchmark of quality and competence.

The CGMA designation is built on extensive research to maintain the highest relevance with employers and develop the competencies most in demand. Go to www.cgma.org to learn more about the designation and its benefits.