Section on Taxation

Inside Basis

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Navigating the Complexities of Cryptocurrency Taxation: An Overview of Broker Reporting Rules

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I. What is broker reporting?

Broker reporting rules, specifically sections 6045 and 6045A of the Internal Revenue Code, play a crucial role in ensuring transparency and accountability in the financial industry. These rules require securities brokers to provide information return reporting, typically using a Form 1099-B, outlining details related to customers transactions. Reporting is essential for tax purposes and helps the Internal Revenue Service ("IRS") monitor and regulate the buying and selling of securities.

Reporting rules like sections 6045 and 6045A require brokers to disclose specific information about their customers including name, address, gross proceeds, basis, and transfer information for each transaction. Brokers keep track of gains and losses applicable to each customer and then report that information to the customer and the IRS.

Recently, digital assets including cryptocurrencies like Bitcoin and Ethereum have surged in popularity and value. Digital assets are vastly different from existing securities in the marketplace. For example, Bitcoin operates on a decentralized network and is not controlled by a single entity. Digital assets have largely escaped taxation and reporting requirements due to their complexity.

Recognizing the potential revenue loss resulting from the taxation gap, the White House has focused its attention on changing the reporting rules to cover digital assets. By including digital assets in the broker reporting rules, the White House predicts a net gain of $27 billion in tax revenue in the next decade.

II. The Infrastructure Investment and Jobs Act brings significant changes

On November 15, 2021, the Infrastructure Investment and Jobs Act (the "IIJA" or "Act") was signed into law by President Biden. The goal of the Act was to bring digital assets under the regime of broker information reporting. Section 80603 of the Act enacts broker reporting rules for digital assets. This Act made two significant changes by amending the definition of broker and creating a definition for digital assets.

First, the IIJA amended the existing definition of broker to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." Second, the IIJA defines digital assets to mean "any digital representation

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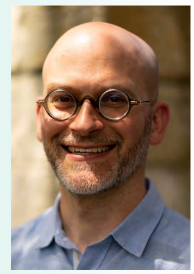
Message from the Chair

Alan S. Williams



It is my honor to serve as Chair of the Section on Taxation for the 2023-2024 fiscal year. As we all continue to return to many aspects of our pre-pandemic, in-person lives, the Section remains committed to providing its members with high-quality opportunities for professional growth, development, and engagement.

Throughout the year, the Section works through the Beyond the Beltway Committee to connect and bolster tax communities outside of the District of Columbia. We are planning in-person events in cities like Atlanta, Boston, Dallas, New York, and St. Louis. The Section also provides virtual and hybrid programming through its monthly Tax Practice & Procedure roundtables, quarterly substantive tax panel discussions, and other ad hoc panels discussing new tax guidance as it is released throughout the year. And our Women in Tax Committee, the Diversity and Inclusion Committee,

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of value which is recorded on a cryptographically secured digital ledger or any similar technology as specified by the Secretary." Two other noteworthy changes in the Act are that digital assets should be regarded as covered securities if acquired on or after January 1, 2023, and made subject to transfer reporting requirements akin to those applicable to other securities in the market.

Transfer reporting for existing securities requires the disclosure of information about the type of security, the total basis of the security, the customer and the broker. The IIJA will now require digital assets to be governed by the same transfer reporting requirements.

Finally, the IIJA stated that the changes mentioned above apply to returns required to be filed and statements required to be furnished after December 31, 2023. The newly released proposed regulations have now pushed this back to 2025.

III. Proposed Regulations for Crypto Broker Reporting

On August 25, 2023, the Treasury Department ("Treasury") and IRS published long-awaited proposed regulations ("Proposed Regulations"), addressing widespread industry concerns raised by the IIJA. The Proposed Regulations specifically addressed the concerns by revising the definitions and limitations for broker reporting. The definition of digital assets' remains consistent with the IIJA, but indicated that Non-Fungible Tokens ("NFTs") and stablecoins are considered digital assets. The definition of a broker used in the IIJA has been broadened, but carved out that those who validate transactions would not be subject to broker reporting (e.g. miners and stakers).

The Proposed Regulations expanded the definition of broker by modifying the definition of "effect" used in the broker definition. Broker will now include any "digital asset middleman" who would ordinarily know or be in a position to know the identity of the party using digital assets for transactions resulting in gross proceeds from the sale. Digital Asset Middleman will include any party that is in a position to know the seller's information and provides a facilitative service to the seller (e.g. decentralized exchanges offering access to smart contracts). Digital asset payment processers will likewise come within the scope of the broker definition. Notably, parties that solely validate transactions will not be included in the broker definition (e.g. miners and stakers). Due to the broad scope of the broker definition, there are industry concerns that individuals or entities, such as website developers and digital asset platforms engaged in smart contract interactions, may inadvertently become subject to broker reporting obligations.

If the Proposed Regulations remain unchanged, then the following dates will apply. Starting January 1, 2025, brokers will be required to provide reports that include the name, address, gross proceeds, transaction ID, and wallet address for every sale they assist with. Starting in 2026, brokers must begin disclosing the basis of the asset being sold. The information will need to be provided on a newly created Form 1099-DA.

IV. Concerns raised by the Regulations

The complexity of digital assets has made it difficult to draft legislation and regulations that adequately cover these products without being overly burdensome. The IIJA and Proposed Regulations drafted expansive definitions for digital assets and brokers which are causing widespread industry concern.

The issue with the broad definitions is that not all digital assets are created equal. While certain assets such as Bitcoin represent value, other digital assets like NFTs represent ownership and origin rather than intrinsic value. Many other uses exist for NFTs, such as event ticketing, collectibles, and proving ownership of tangible and intangible property. The IRS and Treasury must consider the intricacy of digital assets so that unintended assets are not subject to the broker reporting rules.

Overall, the proposed legislation is a positive step for the largely unregulated space, but market participants are concerned that overexpansive regulations could negatively impact digital asset innovation within the United States. In response to the Proposed Regulations, the industry is already seeing a swift departure of industry participants moving to foreign countries with more favorable regulations.

V. Key takeaways for brokers and taxpayers

The introduction of broker reporting rules for digital assets through the Proposed Regulations represent a significant shift in cryptocurrency taxation. While the complexity of digital assets poses challenges in drafting comprehensive regulations, the IRS and Treasury are reviewing comments from the industry and are likely refining the definitions to ensure that unintended assets and ancillary parties are not subject to the reporting rules. The IRS and Treasury have provided transitional guidance for brokers through the Proposed Regulations, delaying mandatory reporting requirements until the 2026 tax filing season.

It is important to be mindful that the IIJA and Proposed Regulations only apply to brokers. Individual taxpayers are still required to disclose any income associated with their digital asset holdings. Individual taxpayers need to continue to track and report any income associated with their digital asset holdings until the brokers' Form 1099-DA adequately tracks and reports this information (expected in 2025). ⌘

Endnotes

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[9]*See Id.*

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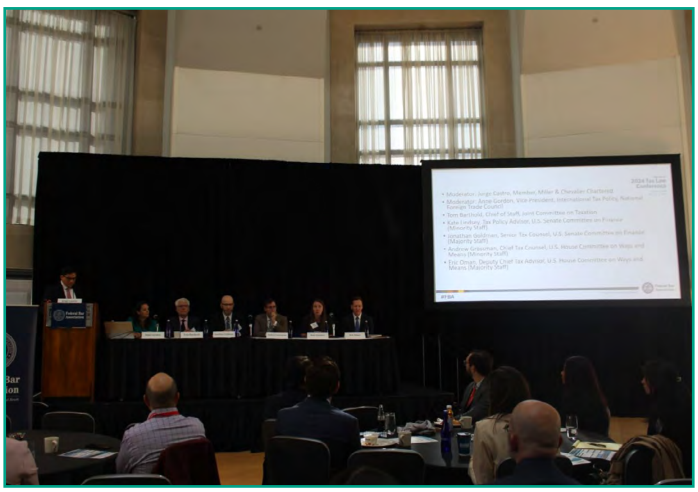
FBA Section on Taxation News

The Kenneth H. Liles award is presented by the Federal Bar Association Section of Taxation annually to recognize practitioners for outstanding service and dedication to tax policy and administration. The award is the Section's highest honor and is awarded to an individual whose career has exemplified the highest standards of tax practice and who has made significant contributions to federal tax policy and the administration and functioning of the tax system. This year, Michael J. Desmond, former IRS chief counsel, was the recipient. Mr. Desmond has been frequently recognized for his work in the public sector and his advancements in tax practice and scholarship. In addition to his role as chief counsel, Mr. Desmond has served in various capacities with the Department of Justice, the Department of Treasury and as a teacher mentoring young practitioners throughout his professional career. ⌘

48th Annual Tax Law Conference

The Section on Taxation recently celebrated its 48th Annual Tax Law Conference with an in-person meeting at the Reagan Center in Washington D.C. on March 1st and continued virtual sessions on March 4th and 5th. Practitioners from both the public and private sector gathered to discuss key tax developments and emerging policy issues in over 15 sessions featuring notable speakers from the Internal Revenue Service, Treasury Department, and leaders in private practice. The conference keynote address was delivered by Danny Werfel, Commissioner of the Internal Revenue Service. ⌘

IRS Commissioner Danny Werfel responding to a question after providing the keynote luncheon.



Practitioners gather to hear the 2024 Tax Legislative update panel, moderated by Anne Gordon and Jorge Castro.

Fred Murray, Matt Cooper, Megan Brackney and Emily Lesniak during a panel presentation on multijurisdictional ethical issues.

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the Young Tax Lawyer Committee are hosting very successful networking events in Washington, DC.

I have been and will continue to be excited to see our members around the country at Beyond the Beltway events; at local programming in Washington, DC; and at the Tax Law Conference in March and the Insurance Tax Seminar in June.

The Tax Law Conference and Insurance Tax Seminar are set to explore cutting edge tax topics and issues. I would like to thank in advance the planning committees, FBA staff, and all of our generous sponsors. None of this incredible programming could happen without you. I strongly encourage all of our members to join one of the Section's many active committees such as the Women in Tax Committee, the Diversity and Inclusion Committee, the Young Tax Lawyer Committee, or the Health and Wellness Committee.

Thank you for supporting the Section on Taxation.
Alan S. Williams, 2023-2024 Section on Taxation Chair

Having read this far, you are clearly interested in the Section. The best way to learn more is to join us and get involved. There is no better time! If you have questions, comments, or ideas regarding the Section, please do not hesitate to reach out to me or any other of our leaders. ⌘

Stronger Enforcement Targeting Tax Evasion Through Cryptocurrency Will Likely Be an Effective Strategy for the IRS

Eduardo Kreimerman Meyohas

The continued rise in popularity of cryptocurrency and digital assets created a new method of tax evasion that has been used to dodge tax collections by the IRS (or "the agency") in recent years. In November 2022, the agency announced that it would bolster its efforts to investigate and prosecute cases involving cryptocurrency. This article analyzes why a more aggressive approach to enforcement is likely to be successful, and tax collection rates are likely to increase, since previous non-prosecution strategies have not worked as effectively to fight this potential tax evasion method.

Cryptocurrency, digital assets, and the IRS

The IRS does not consider cryptocurrency to be real or fiat currency. Instead, as early as 2014, the IRS defined virtual currency as property for federal tax purposes. Announcement 2023-2, issued by the IRS in December 2022, was one of the many recent actions the agency has taken to address the rising intersection of digital assets with tax collection. Though the announcement was limited to outlining reporting requirements for brokers of digital assets, the publication is part of the broader efforts for tax law to catch up with the rapidly-evolving world of digital currency. The IRS Strategic Operating Plan for the 2023-2031 fiscal years explicitly identifies digital assets as an emerging issue for which the agency will allocate more resources.

In recent years, cryptocurrencies have become a popular means for criminals to engage in money laundering and tax evasion. In the same vein, offshore tax havens have been linked to digital cash because some people may turn cash into cryptocurrency, and then transfer it to an offshore account. This process facilitates tax evasion because of the anonymity afforded by cryptocurrency transactions. Further, cryptocurrency is not subject to taxation at source and does not depend on traditional intermediaries like banks, which makes digital assets extremely attractive to tax evaders.

The Criminal Investigation division of the IRS ("IRS-CI") has repeatedly emphasized that cryptocurrency and other digital assets, such as non-fungible tokens (NFTs), are current areas of focus for the agency. The Office of Cyber and Forensic Services was created to better investigate the relationship between tax crimes and cybercrime. The 2022 IRS-CI Annual Report outlines the many efforts that the IRS is implementing to fight tax evasion and related crimes through cryptocurrency; for example, a federal court sentenced the founders of the cryptocurrency company Bitqyck for tax evasion. In that case, the two defendants pleaded guilty to failing to file tax returns, which resulted in an estimated loss of over $1.6 million in tax revenue. In 2022, a study by Barclays Plc found that cryptocurrency investors were not paying at least half of the taxes that they owed to the IRS, which amounted to over $50 billion a year of unpaid taxes.

Motivated by these significant losses in tax collections, the IRS said late last year that the agency would begin pursuing more aggressive enforcement avenues by bringing "hundreds of crypto cases". The IRS-CI is focusing on "off-ramping transactions", which are those were digital assets are exchanged for regular currency, and in which taxpayers are not reporting potential gains. The agency has found early success in this new strategy, since federal courts have consistently authorized it to serve "John Doe" summonses (as described in Section 7609(f) of the Code) on broad classes of cryptocurrency users. The Criminal Division's notable conviction rate of 90.6% in the last fiscal year could be yet another warning sign for those attempting to evade taxes through cryptocurrency as the agency ramps up enforcement in these matters.

Competing views: Aggressive enforcement or a holistic model?

In 1997, James Dale Davidson and William Rees-Mogg predicted, to an extent, the advent of Bitcoin and other similar cryptocurrencies. In "The Sovereign Individual: Mastering the Transition to the Information Age", Davidson and Rees-Mogg wrote about a future of increasingly aggressive tax enforcement as the remedy for tax evasion through virtual currencies. Though some of their predictions bear an eerie resemblance to today's digital assets, commentators like Dashiell C. Shapiro have argued that a holistic approach to collections is more effective than pursuing aggressive enforcement.

In a 2018 article, Shapiro pointed to the Swiss Bank Program and the Foreign Account Tax Compliance Act as examples of more holistic approaches to ensure tax compliance. Shapiro explained that the IRS has been shifting between a model of punitive enforcement and a more customer-centered approach throughout the last four decades. Shapiro cited literature that supports the customer service model as a more effective one compared to enforcement, as well as a Syracuse University study that showed a dramatic reduction in cases referred for criminal prosecution. The study released in 2018 reported that the IRS had made 1,824 criminal referrals in the most recent 12 months; that number is over 50% less than the 3,896 cases that the agency referred in the same 12-month period four years before.

Five years later, the IRS appears poised to be returning to the enforcement model once again, and there is some evidence to indicate that, in the cryptocurrency realm, this is the right move for the agency. Though Shapiro wisely pointed out that the lack of clarity regarding cryptocurrency reporting back then may result in a negative perception of the agency's efforts, the rules today are arguably much

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clearer. Form 1040 prominently asks the taxpayer to check a box if he or she has been engaged in a sale or exchange of digital assets, at the very top of the form. Knowingly failing to report cryptocurrency gains now looks more and more like traditional tax evasion.

In a 2020 Senate hearing, former IRS Commissioner Charles Rettig pointed to the agency's shift back to aggressive enforcement. Rettig bluntly promised to pursue those who intentionally evade their tax obligations. This statement supports the broader idea that all taxpayers need to feel that everyone else is paying what they should in taxes, and that the agency should be collecting unpaid monies from those who do not accurately report their gains. Commissioner Danny Werfel, shortly after his confirmation in 2023, similarly suggested that the agency would focus on enforcement "on areas where compliance has eroded the most".

Recent evidence suggests that stronger enforcement of cryptocurrency-related tax matters is an effective strategy. Last year, the Criminal Division announced that it had doubled the amount of cryptocurrency seizures compared to the past fiscal year. The agency collected over $7 billion worth of cryptocurrency in 2022, and secured more than 1,500 convictions in court. Given that cryptocurrency transactions have historically proven to have higher rates of noncompliance, the shift to aggressive enforcement is likely to improve tax collection rates and serve as a deterrent for would-be tax evaders in this field. Due to the clear question included in Form 1040, taxpayers are effectively on notice that they must report any gains from the broad "virtual assets" category, which certainly includes cryptocurrency. It follows that the IRS will scrutinize these transactions more closely and use the form as evidence of a taxpayer's knowledge that they should have reported any gains. Given the high rates of noncompliance, years after the agency has significantly clarified its requirements regarding digital assets, aggressive enforcement through the criminal justice system appears to be the wiser choice for now.

Conclusion

The IRS should continue to pursue enforcement actions against cryptocurrency-related tax evasion, because more aggressive collection efforts have shown to be more effective in fighting this particular form of tax evasion. As the world of virtual assets continues to rapidly evolve, tax law and criminal enforcement must keep pace with these developments to ensure that all taxpayers pay their fair share of taxes. ⌘

Endnotes

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[2]Notice 2014-21, 2014-16 I.R.B. 938.
[3]Announcement 2023-2, 2023-2 I.R.B. 344.
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[5]Arthur J. Cockfield, *Big Data And Tax Haven Secrecy*, 18 FLA. TAX REV. 483, 524 (2015).
[6]*Id.*
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