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Congress and the IRS Make Moves to Improve Taxpayer Compliance for Cryptocurrency Transactions

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IRS Commissioner Charles Rettig, testifying before Congress in April 2021, estimated the gap between taxes owed and taxes collected in the United States to be close to $1 trillion. While there is some debate as to how much lax reporting on cryptocurrency transactions contributes to this so-called "tax gap," with a market capitalization hovering at the time of writing around $2 trillion, cryptocurrency investments have increasingly become an object of regulatory scrutiny.

Virtual currency disclosure on Form 1040

Beginning with Notice 2014-21, the IRS has consistently taken the view that cryptocurrencies are property for U.S. federal income tax purposes. Absent any specific statutory or regulatory exception, U.S. individual taxpayers are generally required to report gains realized on the sale of property (including cryptocurrency) and pay tax on these gains. To remind taxpayers of this requirement, Form 1040 now specifically asks taxpayers whether they have received, sold, exchanged or otherwise disposed of any financial interest in any virtual currency. (The instructions define "virtual currency" for this purpose as a digital representation of value other than a representation of a "real" (i.e., fiat) currency that functions as a unit of account, a store of value, or a medium of exchange. Cryptocurrencies are included in this definition). The question on Form 1040 requires an affirmative answer of "yes" or "no" from all taxpayers.

A version of the virtual currency question was included on Schedule 1 of Form 1040 when it was introduced in 2019 but, beginning with the 2020 tax year, the question has had a more prominent position on page 1 (and, at that time, asked: "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"). The wording of the question has been modified for the 2021 tax year to remove the word "send" and replace "otherwise acquire" with "otherwise disposed of," consistent with the IRS's focus on identifying taxable events involving cryptocurrency. Generally any transaction involving cryptocurrency during the tax year will require a taxpayer to answer "yes" to this question, with the exception of purchases of virtual currency with real currency (with no further activity).

Expansion of 1099-B and 8300 reporting to digital assets

During his congressional testimony, Rettig also recommended that Congress pass legislation requiring information reporting for cryptocurrency transactions. The Infrastructure Investment and Jobs Act (IIJA), signed into law by President Biden on November 15, 2021, does this.

Under the new law, "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person" is a "broker" for purposes of Internal Revenue Code Section 6045 and required to report those transfers to the IRS on Form 1099-B. The IIJA defines "digital assets" as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary," except as otherwise provided by the Secretary (a broad definition with the potential to encompass a range of crypto-assets, including, perhaps, "non-fungible tokens," or NFTs). Failure to comply with this reporting requirement would trigger penalties under Internal Revenue Code Section 6724.

This definition of “broker,” as amended by the IIJA, has been criticized by some members of Congress and many in the cryptocurrency industry as overbroad, as the language could potentially pick up other participants in the cryptocurrency ecosystem such as miners and wallet developers, rather than merely cryptocurrency exchanges. A bipartisan group of legislators attempted to revise the language to address these concerns, but the proposed amendment did not make it into the final bill. While it remains to be seen how the U.S. Treasury, which will be tasked with implementing the new reporting requirement, will interpret the language, unofficial statements from Treasury indicate that it will not seek to enforce this requirement against miners and hardware developments.

The IIJA also amends Section 6050I, which generally requires taxpayers who receive over $10,000 in cash in the course of the taxpayer’s trade or business to report this receipt to the IRS on Form 8300, to apply to receipts of digital assets. The new reporting requirements are effective for returns required to be filed and statements required to be furnished after December 31, 2023.

The new reporting requirements are projected to raise additional revenue of $28 billion over the next ten years, according to estimates prepared by the Joint Committee on Taxation—a sizable sum, though unlikely to make a significant impact on the tax gap.

Other legislative proposals

Other potential legislative changes affecting the taxation of cryptocurrency transactions are currently under consideration by Congress. The “Build Back Better Act” (BBBA), which was approved by the U.S. House of Representatives only to stall in the U.S. Senate, would expand the “wash sale” rules of Code Section 1091 and the constructive sale rule of Code Section 1259 to cryptocurrency assets. A wash sale is a strategy that effectively provides an investor with a tax-deductible loss while maintaining their position in an investment. Code Section 1091(a) disallows an immediate loss deduction in circumstances where a taxpayer sells at a loss and reacquires the same asset or something “substantially similar” within thirty days before or after the loss sale but is limited by its terms to loss sales of stock, securities, and certain options. Because cryptocurrencies are not considered “securities” for purposes of these rules under current law, crypto-investors have been able to obtain a tax benefit by “harvesting” tax losses during market downswings without actually cashing out of the investment.

The constructive sale rules in Code Section 1259 are intended to address the reverse situation—a taxpayer effectively liquidates an appreciated financial position without recognizing taxable gain. Under current law, disposing of an appreciated financial position in any stock, debt instrument, or partnership interest in a short sale or futures or forward contract for the same or substantially similar property is treated as a constructive sale and therefore a taxable event. The BBBA would limit use of both the wash sale and constructive sale strategies by cryptocurrency investors by extending application of Code Sections 1091 and 1259 to digital assets such as cryptocurrency.

It remains to be seen whether Congress will revisit these proposals in 2022, either as part of the BBBA or a standalone bill. However, the proposed changes suggest growing interest in Congress in closing what some perceive to be "tax loopholes" with respect to this asset class. (The changes to the wash sale and constructive sale rules discussed above were estimated to raise $16.8 billion over 10 years, per the Joint Committee on Taxation.) We will update our coverage on these proposals as discussions in Congress continue.

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