

The Biden Administration Proposes Changes to the Taxation of Cryptocurrency Transactions

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On March 28, 2022, the Biden Administration proposed certain very limited changes to the taxation of cryptocurrency transactions. The proposals do not change the current treatment of cryptocurrency as property for federal income tax purposes, and do not address any of the fundamental tax issues that cryptocurrency raise.

I. Apply Securities Loan Rules to Digital Assets

Under current law, securities loans that satisfy certain requirements are tax-free under section 1058.^[1] The Biden Administration's proposal would expand section 1058 to apply to "actively traded digital assets" recorded on cryptographically secured distributed ledgers, so long as the loan agreement contains similar terms to those currently required for loans of securities. ^[2] The Secretary would also have the authority to define "actively traded" and extend section 1058 to "non-actively traded" digital assets. In addition, the proposal would require a lender to include in gross income amounts that would have been included had the lender not loaned the digital asset (i.e., "substitute payments"). The proposals would be effective for taxable years beginning after December 31, 2022.

II. Apply the Mark-to-Market Rules to Digital Asset Dealers and Traders

Sections 475(e) and 475(f) allow commodities dealers and securities traders to mark-to-market their commodities and securities and treat the gains and losses as ordinary gain or loss. The Biden Administration would extend the mark-to-market election to actively traded digital assets, derivatives on actively traded digital assets, and hedges of those digital assets. The proposal clarifies that digital assets would be treated as a third category of assets, distinct from securities and commodities, to be governed by rules similar to those for actively traded commodities. The proposals would be effective for taxable years beginning after December 31, 2022.

III. Require Information Reporting for Digital Asset Transactions

1. Financial Institutions and Digital Asset Brokers

The Foreign Account Tax Compliance Act (“FATCA”) requires foreign financial institutions to report to the IRS information about accounts held directly or indirectly by U.S. taxpayers. FATCA also requires brokers to report information about their customers to the IRS, including the identity, gross proceeds from sales of securities and certain commodities, and cost basis information for certain securities of customers.

The Biden Administration would expand FATCA’s reporting requirements to accounts owned by foreign persons and maintained at a U.S. office, as well as certain non-U.S. source payments. In addition, financial institutions, including U.S. digital asset exchanges, would be required to report information about certain passive entities and their foreign owners, and digital asset brokers would be required to report gross proceeds and other information with respect to their customers.^[3] The proposals would be effective for taxable years beginning after December 31, 2022.

2. Taxpayers with Foreign Digital Asset Accounts

Section 6038D requires taxpayers with an interest in certain foreign assets with an aggregate fair market value of more than \$50,000 during a taxable year to report the name and address of the financial institution where an account is maintained, the account number, and identifying information about assets not held in a financial account.

The Biden Administration proposes to amend section 6038D(b) to require reporting with respect to any account that holds digital assets maintained by a foreign digital asset exchange or other foreign digital asset service provider. The proposals would be effective for taxable years beginning after December 31, 2022.

^[1] All references to sections are to the Internal Revenue Code of 1986, as amended. Taxpayers that loan securities pursuant to agreements that fail to satisfy section 1058 may be taxable initially and when they receive back the loaned securities.

[2] The securities loan agreement must (i) provide for the return to the transferor of securities identical to the securities transferred; (ii) require payments made to the transferor of amounts equal to all interest, dividends and distributions on the security during the term of the loan; (iii) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and (iv) meet other requirements as the IRS may prescribe by regulation. §1058(b).

[3] A broker would be defined as “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person”.

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