Info Reporting Regime Sets Up IRS Crypto Crackdown

Posted on Sep. 26, 2022

By Jonathan Curry

The third-party reporting of cryptocurrency transactions scheduled to begin next year could revolutionize the IRS's efforts to combat tax evasion of digital assets — if the agency can capitalize on the opportunity.

The combination of a soon-to-be-launched information reporting regime and the IRS's existing tools for tackling cryptocurrency-related tax evasion could make for a robust net to catch digital asset transfers.

"The IRS has become a very digitally minded organization over the last five or six years. A lot of that has been to combat these issues around digital assets and cryptocurrency," said Travis W. Thompson of Sideman & Bancroft LLP.

The Infrastructure Investment and Jobs Act (P.L. 117-58), signed into law late last year, broadened the section 6045 definition of broker to capture anyone "regularly providing any service effectuating transfers of digital assets on behalf of another" for consideration. That will require those brokers to report information on cryptocurrency transactions on a yet-to-be-released Form 1099-DA to both the IRS and the individuals making the transfers.

The intention is to treat cryptocurrency exchanges like stock brokerages, and paradoxically, that may prove to benefit an industry whose origin is rooted in a mistrust of the government.

The crypto market began as a small-scale, decentralized, peer-to-peer system of transactions, but over time it began adopting intermediaries, and not by chance: "This is how people want to interact with a financial system," Omri Marian of the University of California, Irvine School of Law explained.

Roger M. Brown of Chainalysis Inc., a blockchain analysis company that counts the IRS as one of its customers, similarly said he views information reporting as an important step toward maturity for the market. "Most people don't enjoy the forensic exercise of having to compute their tax liability at the end of the year," he told *Tax Notes*. "I get a [Form] 1099-B on my stocks and bonds trading — and I'm happy."

That's also a good thing for the IRS, because the information flowing through those brokers creates an opportunity to introduce accountability to a system of transacting that is otherwise largely self-reported.

Caught in the Net

Brokers and exchanges will have plenty of incentive to comply with the IRS's coming reporting rules because, despite the cryptocurrency world's origins, influential leaders in the industry are now eager for legitimacy and want to promote cryptocurrency as a safe investment, Thompson said.

That's become especially relevant this year as the crypto market underwent — and remains mired in — a crash. In May the market was rocked by the collapse of TerraUSD, a so-called stablecoin, along with its associated token LUNA. Rising inflation has also taken a toll, with leading cryptocurrencies like bitcoin and ethereum losing around 60 percent of their value since the start of the year.

That financial instability justifies more regulation of the industry, said Marian. And more regulation would instill trust in the market by providing assurance that intermediaries "won't collapse every Monday and Thursday," he said.

Thompson likened the new law's approach of putting much of the reporting burden on the initial exchanges to how nontax settlements like lemon law settlements are handled. In those cases, settlement proceeds must be reported on a Form 1099, and the car manufacturer is required to issue a 1099 even if it doesn't have all the proper information, like a Social Security number, from the vehicle purchaser.

"That's kind of how this law is set up," Thompson said. If a taxpayer initiates a transfer from a broker to an external hard drive, the broker is still required to report that transaction — or as much as it can — to the IRS. It then falls on the taxpayer, under penalty of perjury on their tax return, to affirm that they didn't have a sale of their cryptocurrency in that tax year.

"So they're regulating it through the reporting requirements and through the perjury, signing-of-the-tax-returns requirements," Thompson said. Those types of self-reported transactions could be a trigger for an audit, and in that case, the taxpayer will have to prove their position, he observed.

One key determination Treasury will need to make is who falls under the definition of a broker. Exchanges like Coinbase or Kraken will undoubtedly be roped into reporting transfers, but decentralized exchanges pose less obvious choices.

According to Brown, the question of whether an exchange is decentralized isn't binary; rather, "there's many shades of gray" to consider, like whether the exchange monitors or governs the way customers interact, whether it can control or stop trading, and whether it maintains an ongoing business relationship with customers.

In cases when there's "some degree of true decentralization — where there's no entity to regulate — they'll be fully out" of the broker reporting requirements, Brown predicted.

Another challenge is how to properly report gains and losses. If all activity takes place on a single exchange, that's easy to do, Brown said. But for assets transferred to and from an exchange, that exchange won't know what types of transactions took place off it and thus won't be able to report a complete picture of the asset's basis, he explained.

Unlike with stocks and bonds, third-party calculators are available that allow individuals to link multiple accounts and calculate basis, Brown noted. But “each of those calculators can give you different answers,” he said.

According to Brown, the IRS still hasn’t settled on a crypto-tax calculator, and large accounting firms are also still assessing which tools they want to use. “All of these things are giving feedback,” he said. “The ecosystem is immature in many ways. . . . With [the infrastructure bill], it’s a step towards maturation.”

Holes in the Net

No matter how much attention and care the IRS gives to tracking crypto transactions, it seems likely there will always be gaps, but observers say that’s to be expected.

Getting the brokers to comply with the reporting requirements shouldn’t be a challenge because they’ll be legally compelled to. As for taxpayers, “now you’ve got something else entirely,” said Thompson.

What has the IRS “scared the most” about the effectiveness of its information reporting net is a situation in which a taxpayer is holding cryptocurrency somewhere off those platforms, like on an external hard drive, according to Thompson. “How does the IRS even find out about that?” he wondered.

“Putting crypto in cold storage is much like when people used to bury money in their backyard—that was their hiding place for it,” said R. Damon Rowe of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP. “And the IRS still has the same challenges; this is just challenges at the speed of light.”

Rowe, former head of the IRS Office of Fraud Enforcement, said that by and large, casual crypto owners “just want to buy hot dogs and pizza with crypto, or have it just for the sheer novelty of it.” Those types of individuals, along with crypto investors, will stay in the trackable market, he said.

But Rowe predicted that there would be a core group of individuals who don’t want to get entangled in the new reporting regime and will try to find ways to avoid it, whether by sticking to peer-to-peer transactions or moving to the dark net.

Still, observers generally agreed that for most, staying out of the reporting net can last only so long. “Once they come back up for air and want to actually buy something, there’s going to be provisions that will trigger reporting on them,” Rowe said.

Annette Nellen of San José State University agreed. “It’s possible before the reporting officially goes into play that people might want to pull their cryptocurrency out. But in the long run, is that going to help them? I don't think so,” she said. “If they're going to be a bad actor, [there’s a] good chance they’re going to get caught at some point.”

Even if those individuals can hide from the reporting indefinitely, if those assets had been on an exchange before they were pulled out, the records might get summonsed, and the trail could be traced from there, Nellen said.

Marian was also skeptical that the volume of peer-to-peer transactions would create a large enough gap in transaction reporting to be of much concern. "I'm less worried about it," he said.

"They won't be able to catch every single transaction or data point, nor do I think they will try to," Brown said.

Rowe concurred. "Dark market activity isn't bulletproof, but if you're someone who wants to get away with a nominal amount, it'll still be hard for a government agency to expend a lot of dollars chasing a relatively small offender," he said.

Likening the coming reporting regime to the Foreign Account Tax Compliance Act, Rowe added that it might take time to fine-tune it.

The Wider Net

Large swaths of the IRS might still be hampered by outdated systems and paper-based processes, but when it comes to tackling cryptocurrency, the agency has been surprisingly agile.

The IRS already has a substantial cryptocurrency tax enforcement system in place, taking a broad approach that includes placing a cryptocurrency question at the top of Form 1040, the issuance of John Doe summonses to multiple cryptocurrency exchanges, and artificial intelligence and data-analysis-based tools provided by companies like Palantir and blockchain-scanning platforms like Chainalysis.

Those efforts are all designed to identify taxable transactions, and now they're about to be strengthened when the new information reporting regime goes online next year.

By using a "few nodes of discovery" and applying some sophisticated analysis of the blockchain's transactions, the IRS should be able to effectively triangulate a transaction, according to Marian. "The combination of blockchain analysis and information reporting makes the ability of the IRS, and basically any authority, much better at trying to find out who's trying to hide what," he said.

The Office of Fraud Enforcement has overseen Operation Hidden Treasure, the umbrella program leading its cryptocurrency tax compliance efforts. According to Rowe, who left the office in April after serving as its inaugural director, the office makes use of "excellent tools," and crypto-tax enforcement remains a top priority for the agency overall.

Some of those tools even "risk-score" transactions, so that if a transaction is determined to have gone through a dark market, it can be scored in a way that determines if there's a high probability it went somewhere that's associated with human trafficking, weapons sales, or other types of criminal activity, Rowe explained.

Looking Ahead

Treasury and the IRS have yet to issue any regulations implementing the reporting regime or to release a draft of the in-progress Form 1099-DA, but the new information reporting regime is set to go into effect in mere months. Beginning January 1, 2023, cryptocurrency brokers will need to start tracking transfers for tax returns due after January 1, 2024. But that all assumes these rules will indeed take effect as scheduled.

"That's really fast," observed Brown, who added that the private sector usually needs at least a year to implement a new reporting regime on its end and could prod the government into delaying those requirements. Earlier this summer, it was reported that the government intends to delay their implementation. However, that has yet to be publicly announced. The IRS didn't respond to *Tax Notes*' request for an update.

In the meantime, the IRS has been granted an enormous sum of additional funding, thanks to the Inflation Reduction Act (P.L. 117-169), enacted in August. The nearly $80 billion in extra funding over the next decade will "definitely supercharge its cryptocurrency compliance initiatives," according to Thompson, who said it presents the IRS with the opportunity to hire employees with relevant technology-oriented backgrounds, plus invest in new tools.

"It is a brave new world and a very exciting time at the IRS," Thompson said.

Rowe agreed, although he cautioned that the impact might be less immediate than some people envision. "There's this idea that it's going to be like a flash-bang — the flash might be the cash, but the bang comes two or three years later when the new people get trained," he said.

Still, some efforts, like hiring experienced staff from crypto firms, could have a fast impact, Rowe continued. And as long as the IRS chooses the right technology and tools, "that will speed up the flash," he added.

At the same time, the funding also raises the stakes for the agency as it works to get the new reporting system up and running. "Now that they have the opportunity, they can't say there's no funding for it," Rowe said.

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