TOKENS OF AFFECTION AND DISAFFECTION:
An update on the current state of U.S. crypto taxation

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February 2021

Note: This paper addresses U.S. tax issues surrounding cryptocurrencies and other crypto assets. It is an area of tax law that is beset with uncertainties. As such and because the application of tax law is often dependent on a taxpayer’s particular facts and circumstances, you should consult with your tax advisors on the application of the tax rules to you. This article is for information purposes only and is not tax, legal or investment advice.
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A. The crypto around us

In recent years, the volatility in cryptocurrency prices has made the headlines in the financial and popular media. Witness bitcoin. In alternate throes of love and fear, we have seen bitcoin’s dramatic 1,300% price surge in 2017, its subsequent crash during the crypto winter of 2018 and its phoenix-like resurgence to break through $50,000 a bitcoin as of mid-February 2021.

As of February 17, 2021, bitcoin’s market capitalization alone was over US$900 billion. But even during its price surge at the beginning of 2021, bitcoin market capitalization fluctuated wildly dropping at one point US$150 billion in a matter of a few days, again reflecting crypto’s price volatility. Nevertheless, this compares to a market cap for bitcoin a year earlier of US$143 billion.

But the headlines only tell part of the story.

Irrespective of what the correct valuation for crypto assets may be, what seems evident beyond scanning the headlines is how quickly the underlying blockchain and distributed ledger technology is developing. Not only has there been an explosive growth in the number of cryptocurrencies and tokens – the website Coinmarketcap.com lists over 4,000 crypto tokens. But as 2020 drew to a close, the use cases for, and the adoption of, crypto assets and platforms appear to have significantly expanded.

As reported on CNBC on January 4, 2021, global crypto leader Henri Arslanian at accounting firm PwC argued that one of the main factors behind the surge in bitcoin prices from year-end 2020 into January 2021 was the “continuous entry of institutional players” into crypto. He also noted a dramatic increase compared to the prior year of retail investors who now have access to accounts where crypto assets may be purchased and traded.

Retail investors can now easily open an account on one or multiple crypto exchanges or brokerages and begin trading bitcoin and a host of other cryptocurrencies. In 2020, someone with just a PayPal account could buy crypto. But 2020 also saw increased attention toward uses cases for cryptocurrencies and platforms, in particular in the area of decentralized finance.

Its use as a means of payment has been a key part of the vision for cryptocurrencies since the genesis block for Bitcoin was mined in 2009. Now developers are expanding that vision to have crypto platforms, smart contracts and decentralized apps (DAapps) cover not only cross-border payments but borrowing and lending, trading through decentralized exchanges (DEXes) and other financial services.

Retail investors can now purchase stablecoins, such as Tether or USD Coin, designed to obtain a stable price, ‘deposit’ such coins and earn an ‘interest’ return. They can obtain payment cards linked to their crypto accounts.

Moreover, there has been increased development in so-called off-chain or Layer 2 technologies intended to allow underlying blockchains such as Bitcoin or Ethereum to scale. These technologies, for example, may aggregate transactions so fewer transactions need to be confirmed on the underlying blockchain or build additional functionality on top of the underlying blockchains. In response to the growth of these technologies the U.S. Internal Revenue Service (IRS) criminal investigations division issued a request for proposal in September 2020 for vendors to provide technological assistance in the areas of privacy coins and Layer 2 technologies.
The rapid growth of crypto assets and their underlying blockchain technology has resulted in a dilemma for U.S. tax regulators: on the one hand, the size of this activity and the dollar amounts in crypto are too large to ignore; and on the other, the speed at which virtual currencies and other crypto tokens have entered financial markets and everyday life has left regulators little time to build a governance framework.

U.S. tax authorities were initially inclined to steer taxpayers toward existing tax rules that could potentially apply to certain crypto assets but are often not good fits. Under existing guidance, the IRS treats cryptocurrencies generally as ‘property’ rather than as currency. But the property analogy only goes so far.

Beyond this, crypto assets exhibit behavior that property such as a chair or a car would not. What are the tax ramifications of a ‘hard fork’, an airdrop or rewards received through mining or staking? What happens from a tax perspective in an initial coin offering or the issuance of a stablecoin? And what do you do with off-chain transactions?

The IRS issued brief guidance in a 2014 notice which stated that convertible virtual currencies should be treated as property. In October 2019 the IRS added 40 FAQs on its website and a revenue ruling addressing crypto hard forks. But that has been largely it and no regulations exist specifically for crypto.

As such, numerous questions remain unanswered – not just in regards to novel DeFi applications of crypto but even with respect to simply the holding and trading of crypto.

There has also been an absence of guidance on tax information reporting obligations for institutions that are facilitating their customers’ crypto transactions, leaving both the institutions and their customers in an uncertain muddle.

B. A poorly fitting shoe

The U.S. tax authority’s repeated refrain that virtual currency is property, without more, is a poorly fitting shoe from a regulatory and tax compliance standpoint. Though, given the stakes and the expanding crypto ecosystem, more guidance can be expected from the IRS in the near future. In its priority guidance plans for both 2019-20 and 2020-21, the IRS has listed regulations with respect to tax information reporting for virtual currency transactions as a priority guidance item.

C. Implications for taxpayers, financial institutions and tax administration

In the meantime, the IRS has ramped up enforcement efforts and communications to taxpayers to require them to comply with tax rules that might apply to crypto transactions, even as specific rules applicable to crypto remain unwritten. In a schedule to the 2019 individual tax return, the IRS included a question asking taxpayers whether they have entered into transactions involving virtual currencies. The question was moved to the front page of the individual tax return in 2020.

While some tax rules seem relatively straightforward, others are not. And as individuals venture beyond buying and selling bitcoin to obtaining stablecoins and lending and borrowing on decentralized networks, the existing guidance becomes less and less helpful.

Moreover, with the existing state of disparate tax reporting, individuals may have difficulty maintaining relevant data for tax compliance. This likely means that individual taxpayers may need to rely more on the institutions that facilitate their crypto transactions to provide them tax-relevant data in user-friendly formats.

Tax risks and exposure also exist for institutions such as brokers, custodians and exchanges that are facilitating trading in crypto assets as they try to navigate through these uncertain tax waters. Do existing tax reporting rules apply to the crypto transactions that they facilitate? If so, is it clear how certain transactions such as a crypto hard fork should be reported?

In addition, from a customer relationship standpoint, what tax information or tools would customers expect? And how can that data be best conveyed?
As a matter of best practices, institutions that facilitate crypto transactions may need to examine their offered services to determine their obligations under existing tax reporting rules even ahead of further IRS guidance. This is important since failure to report penalties can be significant and noncompliance can also impact a firm’s reputation. Moreover, in the context of crypto trades for example, customers trading in cryptocurrencies may expect certain tax information from their brokers.

For institutions, tax compliance may require building or acquiring systems that are able to sift through internal platform data to produce required tax reporting both to customers and the IRS. Systems may need to be built with enough flexibility to be updated as new tax guidance is issued.

For tax regulators, the work may also just be beginning. Beyond the need to provide clarity on tax classification of cryptocurrencies and other crypto tokens and on applicable third-party tax information reporting, the IRS will need to address the more elusive issues that are raised by the very nature of crypto assets. Current tax information reporting relies on financial intermediaries to report on their customers. What happens to tax information reporting on decentralized networks where there are no intermediaries? Moreover, how does tax guidance keep pace with rapidly evolving technology that has the potential to impact wide sectors of the economy? Finally, given the global aspects of crypto networks, what are the prospects for multi-jurisdictional cooperation or coordination in crypto tax reporting and compliance?

There are more questions than answers at this point. And these issues may require more than a bit of regulatory finesse and perhaps a rethink of compliance incentives and frameworks.

In this paper we discuss some of the U.S. tax considerations and challenges for taxpayers transacting in virtual currencies and tokens, for the institutions that facilitate such trades and for tax governance.

Part I provides a brief overview of distributed ledgers, blockchain and tokens. Part II considers current U.S. tax guidance on convertible virtual currencies and implications for other crypto assets. Part III discusses IRS crypto tax enforcement efforts, the role of third-party tax information reporting and administrative challenges specific to crypto assets and platforms. In Part IV, we conclude with some final thoughts of the current state of crypto taxation.
I. Distributed ledgers, blockchains and tokens

In order to understand tax challenges that arise with cryptocurrencies and other crypto assets, a brief overview of these assets is helpful.

Several terms are key to understanding crypto: they include distributed ledger technology (DLT) and the blockchain. These concepts underlie most existing cryptocurrencies and other crypto tokens. It is also helpful to examine what is meant by tokens.

A. Distributed ledgers

First, what is a distributed ledger and why is this important?

DLT is refers to the technology behind a type of database that is decentralized across multiple participants or nodes within a network. The database is shared, replicated and synchronized across these decentralized points, with participants at each node agreeing to ledger updates through a consensus protocol embedded in the network code.

In effect, DLT avoids reliance on a central authority or intermediary to maintain a ledger or book of accounts. Instead, the participants in the network agree to a consensus protocol to validate and authenticate transactions. There is no one party that keeps the ledger; the ledger is kept at multiple nodes or computer servers that can belong to independent parties and that are updated and synchronized based on the consensus protocol.

A DLT model has benefits and challenges. One benefit is efficiency, especially when you think about global payments. A distributed ledger is not constrained to a single entity that is located in a single jurisdiction – it is by its nature global. From a technology perspective, open networks can allow anyone with a computer and access to the internet to engage in transactions over the network irrespective of location.

This DLT payments model contrasts with traditional banking where a payment sender would need to give instructions to its own bank that may need to transmit instructions to a correspondent bank abroad. The recipient may also need to have a relationship with a bank in this network. Crypto payment platforms have aimed to bypass such financial intermediaries in order to reach end-users that may not have easy access to traditional financing infrastructure.
Another benefit is the potential for reducing counterparty risk, the problem of having to rely on intermediary institutions maintaining separate ledgers and the exposure that occurs when an institution fails. Bitcoin, the largest of the cryptocurrencies by market capitalization, not incidentally arose during the 2008 financial crisis. In DLT, a particular node may fail without affecting the rest of the network or the distributed ledger.

However, participants in distributed ledger networks must solve a host of issues. For example:

- What is a valid update and how does each of the nodes reach consensus? That is, how do you trust a transaction in a system where you do not know your counterparties? There will need to be some sort of consensus protocol.
- How does a semi-anonymous network know you are an authorized ‘sender’? Cryptography often plays a critical role in both consensus protocol and user authentication – hence, we come to the name ‘crypto assets’.
- How does the network keep ‘bad actors’ from corrupting or falsifying data on the distributed ledger? Additional safeguards may need to be built into the consensus protocol or blockchain structure.

B. Blockchain

A second fundamental concept in the crypto world is blockchain. Blockchain might be described as a type of DLT that packages transactions in blocks and updates the distributed ledger one block at a time through a consensus protocol. With a blockchain, one package of transactions or block is added to the distributed ledger in a sequence that connects one block to a subsequent one utilizing cryptography. This creates a chain of validated transactions that is transparent. Each transaction block, once written on the chain and time-stamped, also becomes in practice immutable.

Bitcoin, for example, makes use of blockchain technology, where transfers of bitcoin from one owner to another are recorded in blocks. Blocks are validated and added to the chain through a consensus protocol called ‘proof of work’ (PoW).

Under a PoW consensus protocol, validators called ‘miners’ compete using computers to solve mathematical puzzles that are difficult for them to solve but easy for the network to verify. The successful miner broadcasts its solution to the network which then verifies the answer.

The successful miner generates the next block in the chain through this verification and consensus process and, as an incentive, receives a reward from the network. In the case of Bitcoin, the miner receives bitcoins as rewards. The bitcoin rewards may include newly issued bitcoins from the network as well as coins from fees paid by transaction participants. This activity of generating bitcoin reward through block validation on a PoW network is referred to commonly as ‘mining’.

The expense required to generate the PoW solutions makes it less likely that bad actors would try to spam the system with false transactions since this becomes costly. Moreover, each new block is cryptographically linked to the prior block, making it difficult to change a single block without changes to the entire blockchain. Sufficient concentration (greater than 50%) computer or mining power, however, can impact the security of the network. Moreover, mining consumes a significant amount of energy. But we will discuss more about PoW and other consensus protocols as we consider tax ramifications below.

C. Virtual currencies and other crypto tokens

Notice 2014-21, issued in 2014, was the U.S. Internal Revenue Service’s first formal tax guidance on crypto. In a series of short questions and answers, the notice aimed to provide at least an initial framework for taxing what it called “convertible virtual currencies”.

Virtual currency, the IRS stated in the notice, “is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.” It may act like real currency in some environments, but it is not legal tender in any jurisdiction.

Virtual currency that “has an equivalent value in real currency, or that acts as a substitute for real currency,” is referred to by the IRS as “convertible virtual currency.” What did the IRS have in mind? Bitcoin.

But Bitcoin and other virtual currencies, convertible or otherwise, are only a subset of the crypto asset world. The 2020 OECD global crypto tax summary report titled, Taxing Virtual Currencies: An Overview of Tax Treatments and Emerging Tax Policy Issues, refers to three principal types of crypto assets, which they call tokens:

- Payment tokens – tokens that are intended to be used as a means of payment or a store of value, which would include what the IRS described in Notice 2014-21 as virtual currencies
- Utility tokens – tokens that give the holder the right to access certain services or goods on a network
- Security tokens – tokens that can represent interests in an underlying business, commodity, shares or other asset and may be designed as tradeable assets held for investment
The OECD report is referred to below as the 2020 OECD Crypto Tax Report.

Outside the U.S., tax authorities such as HM Revenue & Customs (HMRC) in the UK have outlined similar demarcations. In the case of the UK, payment tokens are also called exchange tokens.

While the focus of the U.S. IRS has principally been on virtual currencies or payment/exchange tokens, it is important to recognize that there are a wide range of crypto assets that exist outside of this space. Moreover, it is possible that some crypto assets will obtain hybrid token status -- for example, tokens that may be partially payment tokens, utility tokens and/or security tokens.

When we talk about crypto assets from a tax perspective, it is important to understand what type of asset it is. Cryptocurrencies or exchange tokens might be treated very differently from a tax and regulatory perspective than, for example, security tokens.

Tax rules may end up being much more granular in the crypto space. Not only could tax treatment of different token types or hybrid token types differ but given the wide variations in conditions and use with respect to each particular crypto asset, tax ramifications for an individual crypto asset may in the end revolve around its own particular functions and coding.
II. U.S. taxation of crypto assets

A. Property framework under IRS Notice 2014-21

1. Virtual currency is not currency

Recognizing the growth of virtual currencies, the IRS in 2014 issued Notice 2014-21, a brief notice on tax ramifications of taxpayers using what it called convertible virtual currencies (CVCs). For five years following that release, this was the only crypto tax guidance issued by the U.S. tax authority.

The notice applies the definition of “convertible virtual currencies” from a 2013 report issued by the Treasury’s Financial Crimes Enforcement Network (FinCEN): a “convertible virtual currency” is a virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency. A virtual currency, according the notice, is “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.” Bitcoin was specifically referenced as a convertible virtual currency.

Notice 2014-21 clarified one aspect of how to treat such convertible virtual currencies for U.S. tax purposes, that is, they are not to be treated as currencies.

Instead, such virtual currencies are to be treated for tax purposes like property. ‘Property’ covers a wide swath of assets, everything from a chair to a house to stock and securities to commodities. This is problematic from a tax compliance perspective because, especially with financial assets, different tax rules apply to different types of assets.

A “convertible virtual currency” is a virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency.
Being property comes with certain tax ramifications. For example, a person who spends bitcoin to purchase coffee is treated from a tax perspective as selling that bitcoin for the fair market value of the coffee received and must recognize gain if any on the deemed sale of the bitcoin. Unlike rules for individuals using foreign currency (e.g., on vacation abroad), there is no de minimis rule to exempt the gain in such deemed bitcoin sales.

If a holder of a bitcoin were instead an investor and sold bitcoin for cash, the holder would recognize gain or loss based on the difference between the cash proceeds and the holder’s adjusted tax basis in the bitcoin. The gain or loss would generally be a capital gain (potentially eligible for capital gains tax rates) or loss (with limitations on the amount that could offset ordinary income) if the investor held it as a capital asset. If the investor instead traded the bitcoin for another virtual currency, gain or loss would also be recognized with the fair market value of the virtual currency received in the exchange being treated as gross proceeds.

2. Cryptocurrency paid for services

Moreover, if a vendor received convertible virtual currency in payment for services, the CVC was taxable based on the fair market value of the virtual currency at the time received and the amount would be treated like services income. If the amount were for non-employee compensation, the payor would generally have been required to report the payment on a Form 1099-MISC. Since the ruling, this has now changed to a Form 1099-NEC.

The IRS also stated in the 2014 Notice that ‘miners’ who received CVC rewards from their work in validating transactions on a blockchain would be taxable on the CVC received. In fact, the notice argued that this could constitute self-employment income for a miner.

3. Open issues from the 2014 Notice

But the brief 2014 Notice left a host of issues unresolved when it came to crypto taxation. While in some cases CVCs may be held as financial investments, it was not clear whether tax rules that apply to various financial instruments would be applicable in the case of CVCs.

For example, if a holder has acquired multiple units of convertible virtual currency at different points in time at different prices and sells only a portion of her holdings in a sale transaction, which lots or sub-lots would the holder treat as being sold for purposes of calculating cost basis? For stock, U.S. treasury regulations generally provide a ‘first in, first out’ (FIFO) method unless the holder of the stock can specifically identify which lot is being sold. Special average basis lot relief applies to stock in mutual funds. But it is not clear that any of these lot relief rules apply to property like CVCs.

Prior to 2018, section 1031 of the Internal Revenue Code provided broadly for tax exemption for the exchange of like-kind property. Would section 1031 apply to a pre-2018 coin-for-coin exchange where the CVCs in the exchange are different? For example, a trade of bitcoin for an alternate cryptocurrency such as bitcoin cash. What constitutes ‘like kind’ in the crypto world?

Also, in a taxable coin-for-coin exchange, how are proceeds from the deemed sale to be determined? What valuation methodology can be used?

The trader mark-to-market election under IRC section 475(f) is available for traders in securities and commodities. Can a trader in convertible virtual currencies make a section 475(f) trader election for bitcoin trades?

Wash sale rules apply to stock and securities. Could they apply to convertible virtual currencies or other digital tokens? With the advent of bitcoin futures, what about straddle rules?

Then there are the more exotic questions. That is, while classified as property, a CVC exhibits more esoteric life events than property like a chair or a car. CVCs undergo such exotic events, for example, as airdrops, staking as well as mining, and hard and soft forks. Chairs do not do that.

How do you tax something like a hard fork on a convertible virtual currency?

In a hard fork, a portion of the cryptocurrency’s developer community – but not all – may opt for a change in underlying blockchain protocol. For example, a group wants more memory capacity on a transaction block. If disagreement occurs, those on the new protocol and those remaining on the existing diverge and the blockchain splits.

At the split or the fork, one ‘coin’ becomes two separate coins since the blockchain has now branched. A holder of the original coin prior to the fork would generally retain that coin and also receive the new forked coin representing the new branch on the
blockchain. In August 2017, for example, the Bitcoin blockchain forked, and a holder of bitcoin received one new bitcoin cash for each bitcoin held.

Is the new coin received in a fork treated as income? Or is it more like a stock split? Do we allocate basis from the original coin to the old and new coins? Or do we obtain a zero basis in the new coin? How and when do we value the new coin that is received? What if a holder is not able to immediately access the bitcoin cash the holder is entitled to? Possibly lacking dominion and control, to use a tax term?

Due to the number of open questions, advisory organizations such as the American Bar Association, the American Institute of Certified Public Accountants (AICPA), and even the IRS Information Reporting Advisory Committee (IRPAC) had submitted letters to the IRS to request additional guidance on a number of these issues. In the spring of 2019, even the U.S. Congress urged the IRS Commissioner to provide more answers.

The IRS sought to answer some of these questions in a series of FAQs and a revenue ruling on hard forks that were issued together in October 2019.

B. 2019 FAQs and the Hard Fork Ruling

1. Property redux

After a five-year wait, the IRS posted on its website over 40 new FAQs on the taxation of virtual currencies on October 9, 2019. On the same day, the IRS also released Revenue Ruling 2019-24 providing its view of how crypto hard forks should be taxed.

The FAQs, which incorporated much of the guidance of prior Notice 2014-21, reiterated the IRS’s position that convertible virtual currencies like bitcoin should be taxed as property, and the tax rules that apply to property would generally apply to CVCs. Under the FAQ framework, a virtual currency is a “digital representation of value, other than a representation of the U.S. dollar or a foreign currency ... that functions as a unit of account, a store of value, and a medium of exchange” and a CVC is a virtual currency that has an equivalent value in fiat currency or can act as a substitute for such ‘real’ currency.

The FAQs have been expanded since issuance and are intended, as in the case of Notice 2014-21, to apply only to CVCs and CVCs that are generally held as capital assets in taxpayers’ hands. A good portion of the new FAQs reiterates the implications of a CVC being treated as property for tax purposes as announced in prior Notice 2014-21. For example, using a CVC to pay for a service or good is treated as a taxable exchange of the CVC for the fair market value of the service or good.

Thus, paying for a cup of coffee with bitcoin still ends up being a sale of that fractional unit of bitcoin at a price equal to the U.S. dollar value of the coffee.

Also, if a person is being compensated for services, the FAQs state that the “medium in which remuneration for services is paid is immaterial” to whether the payment constitutes wages. If the payment is for wages, employment taxes may be applicable whether paid in bitcoin or cash. For an individual receiving CVC for services, the fair market value of the CVC received is income, valued in U.S. dollars at the time of receipt. That also becomes the cost basis of the holder in the CVC.

An IRS Office of Chief Counsel Memorandum (202035011) released in August 2020 argued that even crypto paid for ‘microtasks’ on certain crowdsourcing platforms is includible in income. These platforms may divide larger tasks into smaller ones that are simple, menial activities but still require some degree of human interaction. Payment for a single microtask in crypto may be for values of less than $1.

These property principles generally make for unwieldy record keeping for those who may wish to use CVC for day-to-day payments, but the FAQs are largely an extension of Notice 2014-21 principles in this regard. No big surprises.

2. Expanded guidance on crypto events

Here and there, however, the 2019 FAQs provided new inklings about tax implications when dealing with certain crypto-specific events. These events include coin-for-coin exchanges, hard forks, mining awards, airdrops and off-chain transactions. There was also some basic guidance on such issues as determining cost basis in CVCs sold or the tax impact of contributing crypto to charities.

But practitioners in particular noted that the FAQs lacked the weight of authority that regulations would have and were less impactful than even rulings or notices published in the Internal Revenue Bulletin. And what’s more, the guidance was not as satisfying and as expansive as one would have liked. In the end, the guidance raises new questions that will leave us once again waiting for more.

We begin with basic issues and then move toward some of the more exotic ones.
(a) Tax lots

It is not uncommon that a taxpayer acquires cryptocurrency at different points in time and thus holds multiple lots of coins with a different cost basis attributable to each lot. Where the taxpayer decides to sell only a portion of such holdings on a particular sale date, the new FAQs indicate that the taxpayer can either utilize FIFO accounting to determine the cost of the lot or lots sold or specifically identify the lot or lots being sold.

In terms of specific identification, current FAQ 39 states:

“You may identify a specific unit of virtual currency either by documenting the specific unit’s unique digital identifier such as a private key, public key, and address, or by records showing the transaction information for all units of a specific virtual currency, such as Bitcoin, held in a single account, wallet, or address. This information must show (1) the date and time each unit was acquired, (2) your basis and the fair market value of each unit at the time it was acquired, (3) the date and time each unit was sold, exchanged, or otherwise disposed of, and (4) the fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit.”

There is no indication though about when the specific identification needs to be made. In addition, it is not entirely clear what regulatory authority the proposed FIFO methodology is based on.

(b) Cost basis

Cost basis in CVCs depend on how the CVC is acquired.

If a CVC is purchased for cash, cost basis is the amount paid for the CVC. If a CVC is received for free in an airdrop it obtains a cost basis equal to the fair market value of the CVC at the time received. That amount is also includible in income.

CVCs received as a gift obtain a tax basis that depends on whether there is gain or loss when the CVC is disposed of. For purposes of determining gain, the gift recipient’s tax basis is equal to the donor’s tax basis plus any gift tax paid on the transfer. For purposes of determining whether there is a loss on a sale, the gift recipient’s cost basis is the lesser of the donor’s cost basis or the fair market value of the virtual currency at the time the gift was received.

In a coin-for-coin exchange (for example, exchanging bitcoin for another cryptocurrency such as ether), the new coin received obtains a cost basis equal to the fair market value at the time received. The coin disposed of in the exchange is deemed sold at that fair market value.

For coins received in a hard fork (discussed below), the IRS is taking the view that the fair market value of the coin on receipt is ordinary income. That amount included in income is also the cost basis of the new coin. Thus, in contrast to treating a hard fork as a non-taxable transaction, there is no allocation of basis from the old coin to the new coin.

(c) Coin-for-coin exchanges

If you exchange one CVC for another, the FAQs confirm that this is a taxable exchange. FAQ 15 states, in particular, that if “you exchange virtual currency held as a capital asset for other property, including for goods or for another virtual currency, you will recognize a capital gain or loss.” This is simply an extension of taxation of property principles assuming one CVC is one type of property and the exchanged CVC is another.

There is, however, no mention in the FAQs of whether a CVC exchanged for another CVC prior to 2018 might qualify as a non-recognition exchange under section 1031 like-kind exchange rules existing prior to modifications made in the Tax Cuts and Jobs Act of 2017. So that question remains open for prior tax years.

It is not uncommon that a taxpayer acquires cryptocurrency at different points in time and thus holds multiple lots of coins with a different cost basis attributable to each lot.
(d) Hard forks

The IRS in the FAQs and in Rev. Rul. 2019-24 also attempted to address one of the more vexing potential tax events in the crypto life cycle: hard forks.

IRS POSITION

A crypto hard fork generally occurs when there is an update to the software protocol that underlies a cryptocurrency that not all developers maintaining the network agree with. In such case, the cryptocurrency’s blockchain undergoes a split, with one blockchain ‘forking’ in two directions – one representing the legacy protocol and one representing the new update.

A fork can result in the creation of a new crypto ‘coin’ representing the new fork on the blockchain.

The IRS position in the FAQs and ruling appears to be that a taxpayer that receives a new coin in a crypto hard fork should be taxable on the value of the new coin at the time the taxpayer obtains dominion and control over the coin. If the taxpayer does not ‘receive’ the new coin, however, then there is no income.

In the case where a coin holder holds its cryptocurrency with an exchange or broker, which holds the private keys to the coins (that is, the exchange or broker holds custody of the coins) and the exchange does not support or allocate the new coins following a fork, it appears that this guidance would mean the coin holder has no taxable income due to the fork. If the exchange or broker supports the forked coin and credits the coin holder’s account with the new coin, then the guidance would argue that this crediting of the new coin is taxable.

But what if the broker or exchange does not support the new coin but the coin holder could transfer the coin to a private wallet and take affirmative steps to obtain the new coin? Or the coin holder could transfer coins to a platform that supports the new coin? Dominion and control can become somewhat murky in such circumstances.

ISSUES WITH THE RULING

Moreover, the revenue ruling appears a bit muddled in that it conflates two different terms: hard forks and airdrops. The revenue ruling describes two scenarios – one where a cryptocurrency undergoes a hard fork but the taxpayer does not receive a new coin and one where the cryptocurrency undergoes a hard fork and the taxpayer receives new cryptocurrency via an airdrop.

An airdrop generally refers to distributions of coins to persons for free (e.g., as part of an incentive to promote a service or perhaps the adoption of a particular cryptocurrency) and is not a part of hard forks. In a hard fork, our understanding is that if a coin holder held a legacy coin in a private wallet at the time of the fork, the coin holder would generally be eligible to claim any forked coin utilizing a platform or wallet that supports the new coin by using the private keys associated with the legacy coin. There is no need for an airdrop.

In an article in Tax Notes titled, Disappearing Forks and Magical Airdrops, authors David Chamberlain, Rodney Mock and Kathryn Kisska-Schulze argued that while airdrops are taxable events, much like prizes or found treasure, the new coin received in a hard fork is simply a split of the original property. The new coin always exists after the fork; it is not and does not need to be airdropped.

One wonders whether the IRS in the revenue ruling has misunderstood the mechanics of a hard fork and sees the perceived airdrop of a new coin as an “undeniable accession wealth” that is therefore taxable. The alternative, as some practitioners have recently argued, might be to see the coin split as simply akin to a piece of land divided into two parcels or a stock split in which no new wealth is created, to use contrasting metaphors. The latter would imply non-taxability.

FURTHER RETHINKING

It is unclear which metaphor is closer to the economics of what occurs in a hard fork. In certain white papers, coin developers have noted that the value of a cryptocurrency is based on consensus, including consensus about the likely success of the underlying cryptocurrency project or the use of the token. Unlike stock which represents value in a business, there may in many cases be no direct correlation between the value of a legacy coin and an objective reference (e.g., assets or earnings).

Does a fork really split and dilute existing value in the legacy coin? Or does it create new value because in essence there is now a separate project in the newly created coin with respect to which the community through consensus provides value? These are questions that the IRS may need to reconsider.

In addition, if hard forks are indeed taxable, there may need to be further clarity on the issues relating to dominion and control.

For coins held in private wallets, what should be the result if a coin holder does not take the technical steps to claim the new forked coin? Does it depend on whether those technical steps are ‘ministerial’ in nature and therefore the coin holder would be treated as constructively receiving the new coin? If so, what constitutes ministerial?

What happens to coins that are not accessible for a period of time after a fork? Presumably, the new coin received as income would be valued as of the time when the coin is accessible? Would different coin holders on different exchanges with different accessibility policies have different income inclusions for the same event?

What if valuation at the time of the fork or receipt is opaque or non-existent? Would income inclusion then default to zero?

Thus, despite an attempt at crypto hard fork taxation guidance, the IRS may still need to answer more questions raised by the guidance itself. It may also need to further elaborate on its
rationale for taxation of forked coins. Interestingly, in several jurisdictions outside the U.S. such as the U.K. and Australia (at least with respect to crypto held for investment), a hard fork itself has not been treated as a taxable event.

(e) Mining and proof of stake rewards

In prior Notice 2014-21, the IRS stated that when a taxpayer successfully mines virtual currency (e.g., uses computer resources to validate Bitcoin transactions), the fair market value of the virtual currency as of the date of receipt is includible in gross income. The new FAQ does not add to this guidance (mining income remains taxable) nor does it discuss taxation of block rewards received in alternative consensus protocols such as proof of stake (PoS).

PoS is an alternative consensus protocol that is becoming more and more popular, given some of the issues arising with respect to proof of work or PoW protocols in particular with energy consumption. In December 2020, Ethereum, the second largest cryptocurrency by market capitalization, began its transition from a PoW consensus protocol to PoS.

Under a PoS consensus protocol, participants that hold interest in a network in the form of coins can be selected to validate a block of transactions. There may be a threshold ownership level to be a stakeholder in this context, the thinking being that the more stake a participant has in the network the less likely it is to harm the network.

‘Forgers’ in this instance are randomly selected at each block generation cycle from stakeholders based on the number of coins that the participant provides as a ‘stake’. Those with more stake have higher chances of being selected. The staked coins are generally made inaccessible for a period of time. This serves as surety that the validator is generating an authentic block, since the stake can be forfeited in cases of malfeasance.

A forger that generates the new block receives staking rewards, again in the form of newly minted coins and/or transaction fees. But forgers in PoS, unlike miners, do not engage in intensive computer puzzle-solving exercises.

Are staking rewards taxable at the time of receipt? If so, are they in the nature of passive income much like interest or are they services and possibly self-employment income as the IRS has stated for mining rewards?

In tax articles, some practitioners have questioned whether a portion or all of such block awards, whether from mining or staking or other validation protocols, should be non-taxable on receipt but only taxable on sale. The metaphor posited is that mining or staking might be seen as activity that creates new coins as part of the validator’s network maintenance function. The validator may be seen as the creator of the coin, much like a shoemaker manufactures a shoe. In such case, perhaps the time for taxing the shoe is when it is sold or so the argument goes.

Mining, staking or other forms for block awards may require further elaboration in terms of tax guidance. For now, the conservative position would be that these rewards are taxable as accessions to wealth based on the IRS position taken in Notice 2014-21 with respect to mining rewards.

(f) Airdrops

The FAQs and Rev. Rul. 2019-24 mention airdrops in the context of hard forks. But an airdrop is often thought of as a separate concept. Giving away free coins is usually a way to promote the coin, it is also another means for introduction of new coins into the network outside of mining or forging.

The FAQs state that an airdropped coin is ordinary income at the time of receipt. This seems to make sense (especially outside the context of hard forks) as a coin holder is receiving a new asset, often unrelated to current holdings.

For example, in 2019, the Stellar Development Foundation reportedly began an airdrop of the Stellar Lumens cryptocurrency to users of Keybase, a messaging app. The total airdrop was said to be worth around $120 million.

From a tax perspective, so-called pennies from heaven are taxable – these airdropped coins may just be that.

(g) Wallet-to-wallet transfers

In FAQ 37, the IRS clarified that transfers of crypto between digital wallets owned by the same taxpayer do not give rise to a taxable event. This seems to be the case even though the blockchain may have recorded a transaction to a new blockchain address.

However, the FAQ did not discuss transaction fees in crypto on such transfers. A participant that transfers crypto to another address must generally pay a transaction fee in crypto. That is in part what a miner or forger receives for its validation work. It would appear from the perspective of the participant paying the fee that this might technically be a deemed sale of crypto that gives rise to a taxable event on transfer. Granted, though, the amounts of such transaction fees and, consequently the amount of crypto that may be deemed sold, are generally relatively small.
(h) Off-chain transactions

The FAQs also mentioned in several instances the possibility of ‘off-chain’ transactions, principally in clarifying how fair market value would be determined in that context.

Given that processing multiple transactions on the blockchain may be costly, off-chain networks may be constructed in effect to net out payments between parties prior to recording on the blockchain.

In such cases, the FAQs indicate that a taxpayer should look to what the fair market value of the relevant coin would be if it had been recorded on the blockchain’s distributed ledger at the time of the off-chain transaction. The implication though is that each off-chain transaction has its own tax consequences and is not ‘netted’ from a tax perspective.

3. Questions remain

With the speed with which blockchain technologies and projects are developing, crypto taxation is an area that begs for more guidance.

Beyond the issues noted above, tax guidance will likely be needed as we see the expansion of some of the use cases for crypto assets beyond payment and store of value paradigms.

In the last 12 months, for example, there has been increased activity in the decentralized finance (DeFi) space, where developers are creating projects that utilize DLT to make traditional financing functions such as lending and borrowing, trading or insurance available on blockchain networks.

What does it mean to borrow cryptocurrency or to provide cryptocurrency to a liquidity pool? Should there be special rules that apply to stablecoins that are designed to maintain a stable price, often by being tied to an external asset like the U.S. dollar?

In its 2019 definition of virtual currency, the IRS appeared to tweak its 2014 definition by excluding from the definition of virtual currency coins that are “a representation of the U.S. dollar or a foreign currency”. This seems to reserve guidance on a digital currency that may be created and maintained by a central bank, so-called central bank digital currencies (CBDCs). Will these CBDCs be treated like real currency?

What about crypto tokens that are not payment tokens? Not bitcoin?

C. Thinking beyond bitcoin

1. The DAO that is not named

Slightly outside the world of convertible virtual currencies, the growth of initial coin offerings (ICOs) and crypto tokens – and the fact that certain of these tokens may be tradeable – raise a plethora of additional tax issues. In part, this is also what is missing from Notice 2014-21: the categories of digital assets that lie outside the bounds of a convertible virtual currency, that is, the crypto assets that are unnamed.

Crypto tokens and ICOs have increasingly caught the attention of the U.S. Securities Exchange Commission (SEC). In July 2017, the SEC issued a report on its investigation on something called The DAO. According to the report, The DAO was an example of a decentralized autonomous organization, a virtual organization “embodied in computer code and executed on a distributed ledger or blockchain.”

The DAO was intended to operate as a for-profit entity that would create and hold a pool of assets obtained through the sale of DAO tokens to investors. The assets would be used to fund projects and holders of the DAO tokens would vote on such projects and stood to share in the anticipated earnings. Thus, the token holders had certain voting and ownership rights. In addition, the report also noted that DAO token holders “could monetize their investments in DAO tokens by reselling DAO tokens on a number of web-based platforms ... that supported secondary trading in the DAO Tokens.”

The SEC concluded that based on the particular terms of these tokens that the DAO tokens were securities which required the issuer and exchange platforms to comply with U.S. securities law requirements.

From a tax perspective, The DAO case prompts tax practitioners to think more broadly about crypto tokens as potential securities and the potential tax classifications such tokens may take. Classification from a tax perspective is critical since as mentioned before different tax rules apply to specific types of financial assets. The trouble is that what a token is classified as really depends – it requires a factual analysis of the terms, rights and other characteristics of a particular token. No one size fits all.

2. Classification of crypto tokens by their terms

Potentially, a token might be treated as a token issuer’s equity or debt. It could also be a deemed partnership interest in the case where there is no entity issuer. It may be treated as a prepayment for the service or product that the issuer is planning to develop from funds raised on the sale of the token. Or possibly a financial contract akin to a swap. Or it just might be treated as a convertible virtual currency (discussed above). It might just all depend on the circumstances.
If a token is classified as an equity interest in a corporation, its taxation may follow rules applicable to stock holdings. Gain or loss is recognized on the sale of the token. Presumably, this might mean that there could be ‘dividends’ if profits are shared among token holders. If the issuer is a non-U.S. corporation, certain tax rules such as passive foreign investment company (PFIC) rules could potentially apply to engender not only an adverse tax result but also compliance headaches.

If the token is treated as an equity interest in a partnership, there are issues with the current flow-through and allocation of income. There would also be partnership tax reporting to attend to.

If the token were a debt interest, there may need to be an analysis as to whether there is original issue discount to be accounted for. This would require current income inclusion and, again, tax reporting.

There are transactional tax issues that may affect a token holder as well. For example, an issuer that is using the initial coin offerings or ICO proceeds to create a new blockchain may initially offer tokens leveraged off an existing blockchain. When the new blockchain is created, it may issue new tokens under the new blockchain and ask initial token holders to swap the old for the new.

Similarly, certain issuers had been making use of what is called a SAFT (Simple Agreement for Future Tokens) as a way to pre-sell tokens. Under the SAFT, an investor pays an amount upfront for the right to receive a fixed number of tokens in the future. Part of the thinking seems to be that while the SAFT might be a security, the future tokens issued when a service or product has already developed might qualify as ‘utility tokens’ that could be freely traded.

However, there has been regulatory scrutiny of SAFT transactions – and there are many unknowns from a regulatory and tax perspective on these issuances and subsequent secondary forward contracts with respect to SAFTs.

From a tax perspective, there is no guidance from the IRS directly on ICO offerings, token swaps and SAFTs. Thus, taxpayers must rely on tax principles that apply to analogous transactions.

Holders, issuers and their advisors would need to analyze the facts and circumstances of each individual token and the particular transaction separately in order to properly classify the token and transaction for tax purposes. Such classification would affect the substantive tax rules applicable to a holder and issuer as well as tax reporting obligations for an issuer or other intermediary. These may differ in many respects from the rules applicable to CVCs.

3. Stablecoins, central bank digital currencies and DeFi

The OECD in its 2020 crypto tax report titled, *Taxing Virtual Currencies: An Overview of Tax Treatments and Emerging Tax Policy Issues*, highlights several emerging trends in the crypto space that tax authorities may need to address.

(a) Stablecoins

One of these trends is the growth of stablecoins. A stablecoin generally refers to a privately issued cryptocurrency that is designed to minimize price fluctuation. This may be accomplished by pegging the value of the stablecoin to a stable real asset such as a fiat currency (e.g., the U.S. dollar) or even commodities.

In some cases, this is accomplished by issuing the stablecoin against a reserve, much like a collateralized issuance. The reserve collateral, for example, may be a single fiat currency or a basket of currencies.

But stablecoins could also be designed to be collateralized by other cryptocurrencies or be non-collateralized, with price stability maintained through an algorithm that may increase or decrease supply of the coin based on demand.

Such cryptocurrencies aim to solve a central flaw of other cryptocurrencies from the perspective of their use as a means of payment: the wild swings in cryptocurrency prices. They are often thought to be an important part of developing decentralized finance networks where participants require a certain amount of price stability in order to borrow, lend or make payment for goods or services.

From a tax perspective, a number of issues arise. For example, would a particular issuance of stablecoins be a taxable event? What if a stablecoin were issued through the deposit of other cryptocurrencies as collateral?

Furthermore, should stablecoins be treated differently from other cryptocurrencies because of a link to a collateralized reserve of fiat currency? What if the reserve were a commodity such as gold? Does that affect the tax characterization of the coin?

But questions go beyond mere tax characterization. For example, to what extent will tax authorities be concerned that a stablecoin pegged to a fiat currency can exist and be transferred easily through a decentralized network? That a stable cryptocurrency would allow taxpayers to more easily hide assets from tax authorities than the traditional bugbears of bearer bonds and offshore accounts?
(b) CBDCs

The rise of stablecoins may in some respect spur central banks to issue their own digital currencies that would provide some of the efficiencies enabled by DLT. Developing central bank digital currencies (CBDCs) has been a growing discussion topic among governmental authorities. In fact, reports from the Wall Street Journal in 2020 noted that China has already started pilot programs of its digital currency.

CBDCs can take different shapes: for example as a currency only to be used by commercial banks and similar financial institutions or as a retail digital currency that could be accessed by a wider swath of consumers.

Would the tax treatment of CBDCs be different from for ordinary virtual currencies? That is, a CBDC would presumably be legal tender in its jurisdiction of issuance and would be guaranteed by the issuing central bank.

The IRS definition of convertible virtual currency would indicate that such CBDCs may be outside the CVC definition. A virtual currency, per the IRS, is a “digital representation of value, other than a representation of the U.S. dollar or a foreign currency.” A CBDC would presumably qualify as a representation of a foreign currency. So potentially other currency rules apply? It is an area to monitor.

(c) DeFi

Finally, projects that aim to utilize blockchain technology to develop decentralized finance platforms are on the rise. These platforms can be varied in function but are designed generally to increase access by users globally to financial services.

DeFi applications include borrowing and lending platforms, decentralized exchanges (DEXes) which are virtual currency exchanges that utilize smart contracts to enforce trading rules and global peer-to-peer payment platforms.

According to figures referenced by the OECD Crypto Tax Report, it is estimated that as of September 4, 2020, US$8.8 billion was locked in DeFi markets compared to US$460 million in the prior year.

Within these DeFi platforms, for example, a user could provide liquidity to a lending pool by ‘depositing’ crypto and receive in return rewards in crypto commonly called ‘interest’. The rewards would likely be treated as taxable income, but tax treatment could potentially be different depending on how the return is structured.

For example, some lending structures may issue the lender a token for providing liquidity. Instead of receiving additional tokens or crypto, the token simply increases in value as interest is earned. In this case, would taxation be deferred until the token is disposed of?

Moreover, how would the lending itself be treated? If one received a token in return for providing other crypto, is that a disposition?

Much in these emerging areas of stablecoins, CBDCs and DeFi remain without tax regulatory guidance. The technology, however, is developing at such speeds that tax authorities may soon need to address their use.
III. Tax enforcement and reporting

A. The taxman cometh

1. John Doe summons

Toward the end of 2016, the IRS filed a request to serve U.S.-based virtual currency platform Coinbase a John Doe summons to have Coinbase provide information on all of its U.S. customers to the IRS for the years 2013-2015. Coinbase is a digital currency exchange and wallet provider that allows customers to transact in a number of cryptocurrencies.

The IRS’s concern apparently was that for all the activity that it knew was going on with bitcoin during those years, only 800-900 taxpayers reported gains related to bitcoin in each of those years. The summons, which was later adjusted to cover those customers transacting at least US$20,000 in value of cryptocurrencies, was approved by a court in November 2017. This led to the release of information on approximately 14,000 U.S. Coinbase customers to the IRS.

An article in the tax journal Tax Notes dated October 25, 2018 reported an IRS official’s confirmation that revenue agents had received the information from the Coinbase summons and that they were “matching it with their assigned work”. The IRS had reminded taxpayers in a release dated March 23, 2018 that taxpayers needed to report income from cryptocurrency transactions. It had also specifically declined to provide any special penalty relief in Notice 2014-21 for failure to properly report virtual currency transactions, even for prior years.

2. 10,000 educational letters

In 2019 there was renewed IRS focus on taxpayer compliance with reporting crypto transactions on tax returns. In addition to the issuance of the crypto tax FAQs in October 2019, it seemed clear that the IRS was ramping up enforcement of crypto transactions.

In the summer of 2019, the IRS announced that it was sending out 10,000 ‘educational’ letters to taxpayers that may have entered into cryptocurrency transactions. Further letters were apparently sent in 2020.

There were three versions of these educational letters. Letter 6174 is more informational and alerts the taxpayer that the taxpayer may have accounts with crypto assets and provides some guidance about applicable tax rules.

A second letter (Letter 6174-A) is still informational but is more strongly worded in that it indicates that the taxpayer may not have
properly reported crypto asset transactions on a tax return and should review their compliance.

Finally, Letter 6173 states that the IRS is aware that the taxpayer has entered into crypto transactions and may not have reported such transactions properly on a tax return and requires the taxpayer to submit a response. Absent a response to the 6173 letter, the taxpayer may be referred to examination.

In addition to the educational letters, the IRS also included in the 2019 Form 1040 individual tax return a new question on Schedule 1. The schedule included a crypto-specific question: "At any time during 2019, did you receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?"

For the 2020 Form 1040, the IRS moved the crypto question to the front page of the return and expanded on its discussion of reportable virtual currency transactions in the instructions.

During 2020, the IRS at least on two occasions also issued requests for proposals (RFPs) to obtain assistance from outside technology vendors in its enforcement actions. In one RFP issued in April 2020, the IRS sought outside assistance to support their virtual currency-related examinations through technology that would be able to sort through taxpayer virtual currency transactions and analyze potential gains or losses. In a separate RFP issued in September 2020, the IRS criminal investigations division requested proposals to assist with analyzing privacy coins such as Monero and off-chain or Layer 2 technologies.

If these actions do not convince taxpayers that the IRS has become serious about crypto tax enforcement, there is also the hint that third-party information reporting is on its way.

B. Third-party information reporting

1. TIGTA report

Given the limited guidance on how virtual currencies should be classified for tax purposes generally and how information reporting for crypto transactions should be handled in particular, the IRS has received a lackluster response in regards to third-party information reporting on crypto transactions.

The Treasury Inspector General for Tax Administration (TIGTA) released a report in September 2020 looking at IRS crypto tax enforcement. The report determined that "it was difficult for the IRS to identify taxpayers with virtual currency transactions because of the lack of third-party information reporting that specifically identifies virtual currency transactions."

Third-party information in the U.S. generally takes the form of Form 1099 filings. Payors generally file Forms 1099 to the IRS with a statement of the same to the recipient for specific payments made during the tax year. The forms alert the IRS of a taxpayer's receipt of income. They also alert the recipient of the same and provides the information the recipient may need to report the income on the recipient’s tax return.

TIGTA in another report found that compliance rates without third-party information reporting can be as low as 37%. But the compliance rates rise to near 93% with third-party information reporting and approach 99% when withholding mechanisms are implemented as well.

In the financial sector, these returns are generally filed by financial intermediaries, including banks, custodians, brokers and third-party settlement processors. Different Form 1099 types (e.g., Form 1099-INT for interest, Form 1099-DIV for dividends, Form 1099-B for broker proceeds) are filed for different income types.

In the crypto area, the challenge for financial intermediaries that may be able to provide such reporting is that the tax rules are unclear about what form type, if any, may be applicable for crypto transactions and also which entities performing which functions within the crypto ecosystem would be responsible.

2. Early foray into reporting with Form 1099-K

Notice 2014-21 mentioned potential tax reporting for persons receiving bitcoin for services and for certain third-party network payments but was largely silent on tax reporting to investors and traders in convertible virtual currencies.

It’s noteworthy that presumably as a result of the IRS win in the Coinbase case, certain customers of Coinbase, GDAX (the Global Digital Asset Exchange operated by Coinbase now rebranded as Coinbase Pro) and digital asset platform Gemini reported receiving Forms 1099-K early in 2018 in respect of the 2017 tax year. Coinbase, though, noted in its website in 2020 that it was no longer issuing Forms 1099-K for trades but would issue Form 1099-MISC for rewards earned on the platform if those exceeded a $600 threshold.
Form 1099-K is an information return generally filed by merchant acquiring entities and third-party payment processors to report credit card payments and third-party network transactions to merchants (think PayPal reporting payments made to Ebay sellers). The form is filed with the IRS and a copy is sent to the merchant.

In effect, this provides the IRS with information on gross payments that may have been made to a merchant and prompts the merchant to report the payments as part of its business income. For third-party network transactions, Form 1099-K filing is only required if a payee has more than $20,000 in reportable payments and has more than 200 transactions. Certain states such as Massachusetts and Vermont, however, have a lower – $600 – thresholds for Form 1099-K state filing.

Initially, a Form 1099-K would seem odd for a cryptocurrency exchange to provide to its account holders that may or may not be merchants. Some may be investors and in the world of stock investing might have expected instead a Form 1099-B that reports gross proceeds from sales of securities and, for specified securities, the cost basis of securities sold during the course of the year.

But a Form 1099-K had the advantage of limiting reporting to those that exceeded the $20,000-and-200 transactions threshold (except for Massachusetts and Vermont customers as noted above). And the rationale might have been that CVC trades such as bitcoin were akin to sales of property.

3. Form 1099-B

For trading in stocks and securities, brokers generally file Forms 1099-B with the IRS to report sales of securities and commodities for cash by customers. These reports include gross proceeds from sales and, for specified securities, the customer’s cost basis. A statement containing the same (and sometimes additional) information is provided to the customer.

This type of information reporting has been lacking in the crypto world. This is likely due to lack of guidance from the IRS about when Form 1099-B reporting should apply to institutions facilitating crypto trades.

In 2019, the IRS added a new project to its annual Priority Guidance Plan: issuing information reporting regulations under section 6045 for virtual currency transactions. Section 6045 is the provision that governs information reporting of transactions by brokers and barter exchanges. This item rolled over into its guidance plan for fiscal year 2020-2021.

Current regulations under section 6045 require brokers and barter exchanges to file Form 1099-B to report specified transactions. Thus, when IRS regulations on information reporting on crypto are released, it is expected that they will impact reporting on Form 1099-B.

Prior to the issuance of the crypto information reporting regulations, it is not entirely clear when Form 1099-B would apply. It is possible that under existing rules certain brokers facilitating crypto trades already has a reporting obligation.

Take bitcoin, for example. There is a view that brokers currently do not need to report on bitcoin sales because it may not be a security. But Form 1099-B reporting applies also to sales of commodities for cash.

Under Treasury regulations, a commodity includes “any type of personal property or an interest therein … the trading of regulated futures contracts in which has been approved by the Commodity Futures Trading Commission.” Bitcoin futures were allowed to be traded on CME and CBOE beginning in December 2017.

Could this potentially bring bitcoin into Form 1099-B reporting as a commodity? Or could an institution find itself subject to barter exchange rules if property (virtual currency) is being exchanged for other property (virtual currency) on its platform – which could also implicate Form 1099-B reporting? Or what if the crypto were not a payment token but a security token? Would Form 1099-B then apply?

There are arguments for and against Form 1099-B reporting obligations in different scenarios, depending on particular facts and circumstances. But there is no certainty.

Nevertheless, as a matter of best practices, institutions may need to examine their offered services and products to determine their obligations under existing law, even ahead of further IRS guidance. Penalties for failures to file tax information returns can be significant. Moreover, noncompliance impacts the firm’s reputation as a trusted institution. Brokers may seek to report gross proceeds from crypto trades on Forms 1099-B, while providing cost basis only in recipient statements to their customers.

In the meantime, some institutions may decide that Form 1099-B reporting is not applicable. If so, many investors may miss out on one of the benefits of tax reporting, which is the receipt of transactional information needed for filing their own tax returns.

Investors must largely track not only their trades and proceeds received but also their cost basis in the crypto assets held. Moreover, regarding coin-for-coin exchanges, they might also need to track the pricing for coins on the relevant transaction dates.

4. Form 1099-MISC

While regulations under section 6045 may elucidate the parameters for Form 1099-B for crypto trades, other Forms 1099 may also be required for crypto transactions. In particular, Form 1099-MISC is the likely default reporting for various crypto rewards.

With the advent of new Form 1099-NEC for 2020, however, payments that constitute non-employee compensation may be reported instead on a Form 1099-NEC.

In addition, if the IRS is correct that a new coin received on a hard fork is taxable, that new coin possibly is also reported on a Form 1099-MISC. Much like a prize or award. Thus, tax reporting for crypto may not be confined to one information return.
5. FATCA

Some thought should be given to offshore reporting, especially for non-U.S. financial institutions or for U.S. institutions with a global presence.

During the past decade, the U.S. Treasury and the IRS have made progress in forcing disclosure of U.S. taxpayers’ financial accounts offshore through implementation of the Foreign Accounts Tax Compliance Act (FATCA). FATCA provisions in essence force non-U.S. financial institutions to disclose U.S. financial accounts or risk being withheld upon when they receive payments in transactions with U.S. counterparties.

With the borderless nature of virtual currencies and crypto assets in general, it is likely that the IRS would want to look at rules under FATCA to assess how they may apply to crypto transactions. Should accounts at institutions facilitating crypto trades be treated as financial accounts reportable under FATCA? If so, who is required to report?

It is interesting to note that on December 31, 2020 the Treasury’s Financial Crimes Enforcement Network (FinCEN) announced in Notice 2020-2 that it intended to amend its rules for foreign bank account reporting (FBAR) to include a requirement on virtual currency as a reportable account. Existing regulations do not define a foreign account holding virtual currency as a reportable account for FBAR purposes. The notice may presage similar guidance in the tax realm as well.

C. Challenges to institutional tax compliance and administration

1. Financial institution exposure and risks

Financial institutions that facilitate crypto holdings and trading face a daunting task in trying to navigate still murky rules when it comes to tax reporting compliance. At the same time, customers navigating similarly murky rules on their end may expect that their financial intermediary should provide assistance on the tax reporting front.

In the end, a crypto exchange, broker or other intermediary will likely need to sit down with their own tax advisors and examine their business through a tax lens. This examination would cover business functions, types of digital assets traded on their platform, nature of customers and payments being made to them. Do they qualify as a broker? A barter exchange? A third-party payment processor? How should the digital assets on their platform be classified for tax purposes?

But also, what are the expectations of customers for tax-relevant data?

Systems may need to be implemented to identify relevant tax reporting data and automate the tax reporting function. The same systems might also serve to address customer demand for tax-related data points that the customer or its advisor may require for tax compliance.

This may require the addition of a customer-facing interface that would allow a customer to access relevant tax information: from transaction history to lot-level cost-basis analysis to gain/loss reports for transactions occurring on the institution’s platform.

Such crypto platforms will need to analyze both tax and business risks and requirements. Not the least of these, whether an exchange or broker may be obligated or not, may be their customer’s expectations in the way of tax information.

2. Tax administration

Third-party information reporting will be key to IRS enforcement of taxpayer payment of taxes related to virtual currencies and other tokens. It can be expected that the IRS will issue guidance that would enhance such reporting with respect to these digital assets. But third-party information reporting may not be enough in the crypto space. The challenges are three-fold.

First, IRS guidance will need to be able to address the speed at which crypto technologies are evolving. In the accounting firm PwC’s annual global crypto tax summary as well as the OECD Crypto Tax Report, the common refrain has been that technological developments have outstripped the tax regulatory framework. This may require a more flexible framework in handling an ever-evolving technology.

A second concerning issue is that third-party information reporting currently relies on financial intermediaries such as banks and brokers to conduct reporting. To the extent financial intermediaries remain largely involved in day-to-day crypto transactions, this may work.

But if some of the DeFi projects achieve their ultimate goals, how do you enforce reporting on decentralized systems with no intermediaries?

Finally, given the borderless nature of crypto, tax enforcement may require global cooperation or at least coordination. Given the progress made with FATCA and the implementation outside the U.S. of the Common Reporting Standard (CRS) for reporting financial accounts, there may be possible models if not frameworks for addressing crypto tax enforcement on a global scale.
IV. Concluding thoughts

The tax challenges surrounding crypto assets present risks for individual taxpayers, institutions handling or facilitating crypto transactions and for the tax authority itself. They beg for additional tax regulatory guidance especially as crypto transactions become more and more pervasive on both the retail and institutional levels.

At this point in time, individuals can easily purchase and trade crypto through brokers and exchanges. They can trade on mobile apps with as much ease as purchasing an e-book or a pen online. It has come to the point where someone with a PayPal account can hold crypto.

But more than this, individuals can also purchase stablecoins and earn ‘interest’ rewards and send crypto globally – and they can borrow and lend crypto. They can store crypto private keys in offline hardware wallets that can later be used to transfer crypto to another account, exchange or person.

DLT and blockchain also have the potential to tokenize a myriad of financial and non-financial assets which may affect a broader segment of financial markets and the everyday economy.

The recent developments in DeFi and stablecoins and discussions of central bank digital currencies provide us a peek into our future. In that future, tax regulatory guidance will need to come to terms with the new technology that by its very nature transcends traditional tax enforcement norms.
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