EXPANDED I.R.S. REPORTING OBLIGATIONS FOR DIGITAL ASSETS

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INTRODUCTION

Advances in digital and distributed ledger technology for financial services in recent years have resulted in dramatic growth in markets for digital assets. This transformation has profound implications for consumers, investors, and businesses in a broad spectrum of areas of vital interest to the United States and the global community. These areas include data privacy and security; financial stability and systemic risk; crime; national security; the ability to exercise human rights; financial inclusion and equity; and energy demand and climate change. In November 2021, non-state issued digital assets had a combined market capitalization of $3 trillion, an extraordinary increase from an estimated $14 billion in November 2016. Surveys indicate that approximately 16% of adult Americans – about 40 million people – have invested in, traded, or used cryptocurrencies. More than 100 nations are exploring or, in some cases, introducing Central Bank Digital Currencies (“CBDCs”), a digital form of sovereign currency.

Expansion of I.R.S. Reporting Obligations

I.R.S. reporting requirements for cryptocurrency and other digital assets have been substantially expanded, and as a result, are expected to have a significant impact on the wide range of businesses and individuals to which they apply. Two of these new reporting obligations were enacted as part of the Infrastructure and Jobs Act, signed by President Biden on November 15, 2021. First, the information reporting requirements for certain brokers have been extended to digital assets. Second, digital assets valued at more than $10,000 are now treated as “cash’’ under IRC § 6050I and must be reported to the I.R.S. when received by any person engaged in a trade or business, in the course of that trade or business.

The third disclosure obligation relates to the I.R.S. Voluntary Disclosure Practice.

On February 15, 2022 the I.R.S. announced that Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*, has been revised to include an expanded section on reporting cryptocurrency.

Executive Order

On March 9, 2022, President Biden signed the “Executive Order on Ensuring Responsible Development of Digital Assets.” Section 1 of the Order explains the government’s policy with respect to digital assets as follows:

> While many activities involving digital assets are within the scope of existing domestic laws and regulations, an area where the United States has been a global leader, growing development and adoption of digital assets and related innovations, as well as inconsistent

> controls to defend against certain key risks, necessitate an evolution and alignment of the United States Government approach to digital assets. The United States has an interest in responsible financial innovation, expanding access to safe and affordable financial services, and reducing the cost of domestic and cross-border funds transfers and payments, including through the continued modernization of public payment systems. We must take strong steps to reduce the risks that digital assets could pose to consumers, investors, and business protections; financial stability and financial system integrity; combating and preventing crime and illicit finance; national security; the ability to exercise human rights; financial inclusion and equity; and climate change and pollution.

The new I.R.S. disclosure obligations may be viewed as important beginning steps in effectuating the policy objectives of the United States with respect to digital assets.

This article provides an introductory explanation of these new disclosure duties and discusses some of the many intriguing questions presented by these reporting requirements.

DIGITAL ASSETS

The Internal Revenue Code now defines "digital asset" as follows:

> Except as otherwise provided by the Secretary, the term 'digital asset' means any digital representation of value which is recorded on a cryptographically secure distributed ledger or any similar technology as specified by the Secretary.[1]

The I.R.S. is drafting regulations that will explain and amplify the statutory definition. The effective date of the new definition is January 1, 2023.[2]

It is useful to compare this definition of "digital asset" with the definition contained in the Executive Order. Section 9 of the Order states as follows:

> (a) The term 'blockchain' refers to distributed ledger technologies where data is shared across a network that creates a digital ledger of verified transactions or information among network participants and the data are typically linked using cryptography to maintain the integrity of the ledger and execute other functions, including transfer of ownership or value.
>
> (b) The term 'central bank digital currency' or 'CBDC.' refers to a form of digital money or monetary value, denominated in the national unit of account, that is a direct liability of the central bank.

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[1] Code §6045(g)(3)(D). References to the Secretary that appear in the Code relate to the Secretary of the Treasury or a delegate, which typically means the I.R.S.

[2] Code §6045(g)(C)(iii).

(c) The term 'cryptocurrencies' refers to a digital asset, which may be a medium of exchange, for which generation or ownership records are supported through a distributed ledger technology that relies on cryptography, such as a blockchain.

(d) The term 'digital assets' refers to all CBDCs, regardless of the technology used, and to other representations of value, financial assets and instruments, or claims that are used to make payments or investments, or to transmit or exchange funds or the equivalent thereof, that are issued or represented in digital form through the use of distributed ledger technology. For example, digital assets include cryptocurrencies, stablecoins, and CBDC. Regardless of the label used, a digital asset may be, among other things, a security, a commodity, a derivative, or other financial product. Digital assets may be exchanged across digital asset trading platforms, including centralized and decentralized finance platforms, or through peer-to-peer technologies.

(e) The term 'stablecoins' refers to a category of cryptocurrencies with mechanisms that are aimed at maintaining a stable value, such as by pegging the value of the coin to a specific currency, asset, or pool of assets or by algorithmically controlling supply in response to changes in demand in order to stabilize value.

TAX CONSEQUENCES OF VIRTUAL CURRENCY

In I.R.S. Notice 2014-21, the I.R.S. announced the position that virtual currency, including cryptocurrency, is treated as property for Federal income tax purposes. The Notice provides examples of how well-established tax principles applying to transactions involving property apply to virtual currency. Virtual currency is defined by the I.R.S. as a digital representation of value, other than a representation of the U.S. dollar or foreign currency, that functions as a unit of account, a store of value, and medium of exchange. Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are recorded on a distributed ledger, such as a blockchain.[3]

The I.R.S. expanded its guidance on virtual currency with the issuance of Frequently Asked Questions on Virtual Currency Transactions,[4] which includes useful information for individuals who hold cryptocurrency as a capital asset and are not engaged in the trade or business of buying and selling cryptocurrency.

I.R.S. Form 1040 now asks the following question: "At any time during 2021, did you receive, sell, exchange or otherwise dispose of any financial interest in virtual currency?" The taxpayer must answer this question. A willfully false response to this question on a tax return filed with the I.R.S. is a felony.[5]

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[3] See here for more information.

[4] See here.

[5] Code §7206(1).

BROKERS

Code §6045 establishes reporting obligations for persons doing business as a broker. Section 6045 requires brokers that are dealers/middlemen in "covered security" transactions to issue a Form-1099-B to both the brokers' customers and the I.R.S., identifying the sales of securities through the broker, the customer's adjusted basis in the security, and the proceeds of the transaction. The amended statute expands the definition of a broker and expands the definition of a "covered security" to include digital assets. As a result, the Form 1099-B reporting obligation extends to digital asset transactions conducted through brokers.

The term "broker" has been expanded to include:

> [A]ny person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another.[6]

This definition clearly applies to cryptocurrency exchanges, which are digital platforms that allow users to trade cryptocurrency and other digital assets for other digital assets as well as fiat currencies such as the U.S. dollar or foreign currency. Questions have been raised as to whether this new definition of a "broker" extends to other participants in the development of digital assets, such as miners, providers of digital wallets and developers of new digital assets. The scope of the term "digital assets" is uncertain. The regulations may amplify these definitions and there may be additional legislation that clarifies these new reporting obligations.

As a result of the new reporting obligations of brokers, the underreporting of cryptocurrency gains is expected to diminish. The Joint Committee on Taxation estimates that these new reporting requirements will raise more than $27 billion over ten years.[7]

TRADES AND BUSINESSES THAT RECEIVE DIGITAL ASSETS

Code §6050I, enacted in 1984, requires that any person who is engaged in a trade or business and who, in the course of that trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) must file a return reporting certain required information. The return is Form 8300, and it currently requires information concerning

- the identity of the individual from whom the cash was received,
- the person on whose behalf the transaction was conducted,
- a description of the transaction and method of payment, and
- the business that received the cash.

Cash for purposes of the statute now includes any digital asset as defined in Section 6045(g)(3)(D).

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[6] Code §6045(c)(1)(D).

[7] Report, Joint Committee on Taxation, JCX-33-21 (Aug. 2, 2021).

According to the Form 8300 Reference Guide,[8] the information contained in the form assists law enforcement in its anti-money laundering efforts. Compliance by businesses with this reporting obligation provides authorities with an audit trail to investigate possible tax evasion, drug dealing, terrorist financing and other criminal activities. The willful failure to file I.R.S./FinCen Form 8300 by a recipient is punishable by up to five years in prison, and a maximum fine of $250,000 for an individual and $500,000 for a corporation.[9] A recipient who willfully files a materially false or incomplete Form 8300 is punishable by up to three years in prison and a maximum fine of $250,000 for an individual and $500,000 for a corporation.[10] Civil penalties for knowing violations Code §6050I can be severe.[11] The I.R.S. adjusts the penalty amounts annually for inflation.

"A voluntary disclosure does not guarantee immunity from prosecution. Rather, it will be considered along with all other facts and circumstances in deciding whether to recommend prosecution to the Department of Justice."

I.R.S. CRIMINAL INVESTIGATION (I.R.S.–CI) VOLUNTARY DISCLOSURE PRACTICE

I.R.S.-CI Voluntary Disclosure Practice refers to the long-standing practice of I.R.S.-CI that provides taxpayers with potential criminal exposure for the willful failure to comply with tax or tax related obligations a means to come into compliance with the law and potentially avoid criminal prosecution. A voluntary disclosure does not guarantee immunity from prosecution. Rather, it will be considered along with all other facts and circumstances in deciding whether to recommend prosecution to the Department of Justice. A voluntary disclosure requires the applicant to be timely, truthful, and complete in making the disclosure. During the voluntary disclosure process, the applicant also must

- cooperate with the I.R.S. in determining the tax liability and compliance reporting requirements;
- cooperate with the I.R.S. in investigating any enablers who aided in the noncompliance or were in any way involved in the noncompliance;
- submit all required returns, information returns and reports for the disclosure period; and
- make good-faith arrangements to fully pay the tax, interest, and penalties determined by the I.R.S. to be applicable.

Taxpayers who did not commit any tax or tax related crimes and wish to correct mistakes or file delinquent returns have other options available to comply with their tax and reporting obligations.

The starting point for making a voluntary disclosure is the submission of Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*. On February 15, 2022, the I.R.S. announced that Form 14457 had been revised, including an expanded section on reporting virtual currency. The previous version of Form 14457 provided checkboxes for applicants to disclose cryptocurrency noncompliance that they wanted to report. Disclosing cryptocurrency under the old form did not always apply well to virtual currency holdings.

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8 See here.

9 Code §7203.

10 Code §7206(1).

11 Code §§6721 and 6722.

The revised Form 14457 has a separate section for reporting virtual currency holdings. The taxpayer is required to disclose all domestic and foreign noncompliant virtual currency owned or controlled by the taxpayer or which the taxpayer beneficially owned directly or indirectly during the disclosure period. For each virtual currency holding the taxpayer must report the following information:

- The name of the virtual currency
- The acquisition and disposition dates
- The identifying number or other designation for the holding
- The account holders

The instructions for line 13 in revised Form 14457 note the following about virtual currencies:

> Virtual Currency is a dynamic area, and for purposes of this form encompasses assets beyond what many would define as virtual currencies.

The instructions also explain that the listings of virtual currency for the disclosure period must include assets acquired or disposed of during the disclosure period and include those held through entities.

The applicant is further instructed that if a "mixer" or "tumbler" were used in connection with any virtual currency transaction, the taxpayer is required to identify the "mixer" or "tumbler" used and the reason for its use. A "mixer" or "tumbler" is a service offered by certain providers that is employed to conceal or disguise the source of funds used in a transaction. They are frequently used to hide an illegal source of income or assets. The I.R.S. Voluntary Disclosure Practice is not available to taxpayers with illegal source income determined under applicable Federal law. Consequently, the involvement of a mixer or tumbler is a "red flag'' that the taxpayer may not qualify for a voluntary disclosure.

CONCLUSION

Technological advances in the digital asset sector and the transactions which they affect are occurring at a rapidly growing pace. Recent developments in I.R.S. reporting obligations for digital assets are part of a new effort in this dynamically evolving area to safeguard the revenue system on which our nation depends. The stakes are high for the I.R.S. and the risks may be higher for those who fail to comply with the new rules.