CRYPTO TAXATION, ENFORCEMENT AND REPORTING

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Investors in digital assets most likely do not consider taxation the most exciting aspect of their investment. The Internal Revenue Service (IRS) has been working on the tax compliance, enforcement and reporting of digital asset transactions, which is very complex and continues to evolve. Per the IRS, digital assets are broadly defined as any digital representation of value that is recorded on a cryptographically distributed ledger. This includes convertible virtual currency, cryptocurrency, stable coins and non-fungible tokens (NFTs).

In Notice 2014-21, IRS classified virtual currency as property for tax purposes. Any gain or loss upon the exchange of virtual currency for other property is a taxable transaction. The calculation of gain or loss is measured by comparing the fair market value of the property received in exchange to the cost basis of the virtual currency sold, or vice versa.

The mining of virtual currency is a taxable event. If someone succeeds in mining virtual currency, the taxable amount will be fair market value on the date of the receipt and would need to be included in gross income. If the mining constitutes a trade or business and is not undertaken as an employee, the net earnings would be subject to self-employment tax.

In 2020, the IRS issued a memorandum regarding the tax consequences of receiving convertible virtual currency for performing microtasks through a crowdsourcing or similar platform. The IRS concluded that this is a performance of services by the individual in exchange for convertible virtual currency and must be reported as ordinary income subject to self-employment tax. For investors buying and selling cryptocurrency, the IRS classifies digital assets as property, and it is not subject to wash sale rules.

The IRS has launched an initiative to address the unreported crypto currency taxable income. In 2019, the agency sent out more than 10,000 education letters to taxpayers involved in virtual currency transactions. In 2021, the Federal Court in the Northern District of California authorized the IRS to issue "John Doe" summonses to crypto exchanges seeking the identities of U.S taxpayers who conducted at least the equivalent of $20,000 in transactions involving cryptocurrency in the years 2016 to 2020. In 2022, the owners of a cryptocurrency company were sentenced to eight-year federal prison terms for tax evasion. Taxable crypto transactions must be reported whether or not a taxpayer receives a Form 1099. To date, IRS enforcement has focused on individual taxpayers and not corporations or partnerships.

The Infrastructure Investment and Jobs Act requires Gross Proceeds and Cost Basis Reporting by brokers dealing in digital assets beginning in 2023. It also identifies digital assets as the equivalent of cash, requiring any person in a trade or business to report any one transaction (or two or more related transactions) involving $10,000 in cash/digital assets to the IRS on Form 8300. Digital assets taxation, enforcement and reporting willevolve in the coming years. The challenges to IRS will grow as different kinds of digital assets are introduced by the crypto world.