Journal of Economics and Behavioral Studies (ISSN: 2220-6140)
Vol. 14, No. 1, pp. 1-5, March 2022

The Confusing World of Cryptocurrency and Tax Compliance Issues

Constance Crawford[1], Corinne L. Crawford[2] & Glenn C. Vallach[3]
[1&3]Ramapo College of NJ, 505 Ramapo Valley Road, Mahwah, NJ USA
[2]BMCC, 199 Chambers Street, New York, NY USA
ccrawfor@ramapo.edu, ccrawford@bmcc.cuny.edu, GVallach@ramapo.edu

Abstract: Subtitle A, of the Internal Revenue Code (IRC), contains regulatory provisions regarding the federal taxes imposed on the income of both individuals and corporations. The IRC guidance is intended to provide a determination of all income that must be reported on tax returns and potentially could become subject to an income tax. A new form of currency, known as cryptocurrency appeared on mainstream trading platforms beginning in 2009. Bitcoin initially was the most widely recognized digital currency but other virtual currency versions soon followed. Initially, taxpayers mistakenly believed that cryptocurrency transactions were not subject to Subtitle A of the IRC. Therefore, crypto transactions were assumed to be non-taxable and non-reportable for tax purposes. However, within a few years of the introduction of Bitcoin into the US economic system, the Internal Revenue Service (IRS) introduced tax guidance pertaining to cryptocurrency transactions. In 2014, the IRS responded with Notice 2014-21 as the popularity of Bitcoin grew exponentially. The IRC guidance stated that cryptocurrency must be treated as property for federal tax purposes. The tax implication of the IRS guidance was that cryptocurrency transactions would result in either a gain or loss for tax purposes on Schedule D. This guidance resulted in a recognition that all cryptocurrency transactions would be subject to federal income tax.

Keywords: *Cryptocurrency, tax evasion, analytics.*

1. Introduction

The IRS began targeting cryptocurrency users once the use of cryptocurrency, as an acceptable form of payment, became commonplace. Beginning in 2020, the IRS added a question to the front page of the 1040 tax form asking taxpayers, “At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency” (Baker & McKinney, 2021). While technologies like crypto and non-fungible tokens (NFTs) are designed to be invisible, the mainstream use of these novel payment forms warranted an enhanced investigation by the IRS regarding the tax consequences of cryptocurrency exchanges. The IRS needed to infuse data analytic technology into the tax audit process in an attempt to identify questionable transactions that would fall within the realm of novel cryptocurrency taxable transactions (Aued, 2021). Some recent technological advances that are now embedded within IRS audit guidelines focus on providing the IRS with enhanced investigative tools. These advanced tools are designed to uncover problematic crypto transactions that had been previously hidden from the focus of the tax auditors (Gilman, 2021). With the infusion of advanced technology, like data analytics and artificial intelligence into the IRS’ toolbox, these technological advances will enable the IRS in to sift through billions of transactions in the digital world and make the tax audit process more efficient for investigators (Cohn, 2021).

2. The Complex Definition of Cryptocurrency

Cryptocurrency has been defined as a decentralized digital form of money that utilizes the blockchain technology process (Ashford & Schmidt, 2020). Cryptocurrency is viewed as an alternative monetary system by many economists throughout the world and has the unique ability to limit the amount of substitute monetary supply (Edison, 2021). Cryptocurrency can be used for day-to-day routine household purchases or, more commonly, as an investment similar to equity purchases (Ashford & Schmidt, 2020). According to the Open Markets Institute, the most recognizable cryptocurrency, Bitcoin, (BTC) was first introduced to the world of finance in 2008. Interestingly, cryptocurrency is not managed by any oversight akin to the US Dollar or the Euro but is essentially managed via the internet by crypto users (Ashford & Schmidt, 2020). The cryptocurrency exchanges capture individual transactions via a computer program known as blockchain. All transactions are recorded essentially online in “blocks” and then are linked together in a “chain” now known familiarly as” blockchain” (Ashford & Schmidt, 2020). Now, interestingly, you cannot hold or see cryptocurrencies like Bitcoin, but the cryptocurrency is available in an investor’s online crypto wallet

(Gilman, 2021). Therefore, cryptocurrency is essentially a currency driven by a market perception of value along with the virtual currency's ability to be used as a unit of exchange for commerce (Kelleher, 2021). It is difficult to "value" a cryptocurrency like bitcoin because it requires the market to predict the adoption rate of bitcoin as an international form of currency which is a subjective valuation process at best (Kelleher, 2021).

3. Why is Cryptocurrency a Problematic Tax Issue?

The major difficulty cryptocurrency poses to the IRS is the failure of tax regulators to conceptualize what cryptocurrency really represents as it pertains to a taxable event. In addition, the anonymity of the ownership of cryptocurrency provides ample opportunity for taxpayers to engage in unique and at times problematic transactions resulting in the IRS being unable to identify the taxpayer involved. Most often, unless the IRS is notified by a reporting third party, the questionable transaction becomes essentially an invisible event. Adding to the complexity of the cryptocurrency discussion is the failure of the IRS to provide clear guidance pertaining to the tax consequences of cryptocurrency trades and exchanges. For example, there is much confusion as to whether cryptocurrency transactions should be viewed as a form of money, or as a security. Depending on the viewpoint, some cryptocurrency transactions identified as security transactions would fall under the trading requirements of the Security and Exchange Commission (Baker & McKinney, 2021). To add an additional layer of confusion to the cryptocurrency world, some participants view cryptocurrency as a "like-kind"1031 deferred taxable event (Steverman, Ballentine & Moore, 2021). Interestingly, the IRS does not view cryptocurrency as an actual currency, but rather as a capital asset (Baker & McKinney, 2021).

Given that perspective, cryptocurrency should be reported at the acquisition cost and if at a later date, the cryptocurrency is exchanged for another asset, a potential gain or loss may result (Cohn, 2021). In 2020, the IRS included a specific question on individuals' 1040 tax forms regarding whether the taxpayer engaged in any virtual currency transactions during the year (Baker & McKinney, 2021). The IRS queried each taxpayer on whether they engaged in the buying, selling, exchanging or disposition of virtual currency during the 2020 tax year (Baker & McKinney, 2021). The IRS estimates that during the 2021 tax year, taxpayers aggregating 18-20 million will answer yes to these virtual tax questions (Baker & McKinney, 2021). The reporting problem faced by the IRS regarding these virtual transactions is their reliance on the truthfulness of the taxpayer to essentially "self-report" their virtual currency transactions. But taxpayers should be aware, that failing to respond truthfully to that question on your 1040 tax return could make the taxpayer subject to both civil and criminal tax fraud (Baker & McKinney, 2021). The lack of documentation and record-keeping available to the IRS, for audit purposes, and taxpayers, for reporting purposes, only creates more of an opportunity for inaccurate virtual transaction reporting.

What are the Tax Implications of Virtual Currency Transactions?

The most common way the IRS is advised of a taxable event is through the filing of required tax documents by third parties. All employers must report to the IRS, employee wages on Wage and Tax Forms (W-2) as well as financial institutions who must report all equity trades on Form 1099. The IRS is in the process of drafting tax guidance that would require all cryptocurrency brokers to report any virtual currency transactions to the IRS as well. Congress is currently debating whether any transaction exceeding $10,000 should be required to be reported to the IRS in an attempt to deter tax avoidance schemes (Steverman, Ballentine & Moore, 2021). The intent is for the IRS to be able to levy capital gains taxes resulting from all crypto trades above $10,000. These yet-to-be enacted regulatory guidelines continue to create a confusing compliance landscape for both cryptocurrency brokers and their clients (Steverman, Ballentine & Moore, 2021). To further complicate the current tax environment, the IRS is contemplating embedding unique and unusual tax consequences into these new tax proposal guidelines. For example, using cryptocurrency to purchase either a hot dog or a luxury car, like a Tesla, might result in an increase in the cryptocurrency value exceeding the initial purchase price and thus triggering a capital gain tax event (Steverman, Ballentine & Moore, 2021). Making the tax consequences even more perilous is the fact, that most cryptocurrency users are blissfully unaware of any tax implications when they engage in virtual currency transactions (Baker & McKinney, 2021). It is apparent, that Congress needs to provide clear IRS tax guidance, relating to both reporting and tax filing requirements for all cryptocurrency transactions.

Unfortunately, ignorance of the tax law is not a viable defense for any taxpayer attempting to explain their non-compliance with tax guidelines. However, the IRC must provide clear and specific tax reporting guidelines for all taxpayers to follow in the preparation of their tax returns. The mere inclusion of vague references by the IRS to potential taxable events will only serve to create a disgruntled and confused taxpayer. Unclear tax guidance provides incentives for opportunistic tax avoidance strategies aimed at finding ways to circumvent the intent of perceived problematic tax regulations. Interestingly, all taxpayers can engage in tax avoidance activities, it is only when the threshold advances to tax evasion does a fraudulent event occurring. **Unfortunately,** due to the confusion of the ever-evolving crypto world, some taxpayers believe that cryptocurrency transactions are unfairly being subjected to "double taxation" (Baker & McKinney, 2021). Both a vendor, who would be required to report revenue received and a buyer, who would be required to report any potential gain on asset value appreciation for the transaction, will both be required to pay taxes on the same transaction (Baker & McKinney, 2021). The perception of an unfair double taxation result will create a potential public relations nightmare for Congress and the IRS, which they will need to correct if they expect to rely on self-reporting crypto taxpayers.

IRS Options Regarding Cryptocurrency Tax Compliance

The IRS has a plethora of tax tools available to them as they attempt to navigate the uncharted terrain of cryptocurrency transactions. Tax amnesty opportunities have been a popular option the IRS has offered taxpayers for many years in an attempt to encourage self-reporting of foreign account disclosures (Baker & McKinney, 2021). The IRS is currently contemplating a similar tax amnesty strategy for unreported cryptocurrency transactions. Taxpayers may soon be offered an opportunity to voluntarily disclose unreported crypto accounts and transactions without fear of reprisals by the IRS (Baker & McKinney, 2021). Additionally, the IRS has to its' avail, the tax whistleblower statute. This statute provides a crypto vendor, an incentive of 30% of any tax collected if the vendor reports a crypto transaction to the IRS that they identified as a tax evasion transaction (Baker & McKinney, 2021). The Biden administration is currently reviewing proposals that would increase the IRS' tax enforcement budget aimed at requiring banks and other financial institutions to report information regarding all customer account activity including any cryptocurrency transactions (Cohn, 2021).

Additionally, the IRS is increasing its use of Artificial Intelligence (AI) and data manipulation opportunities to better identify patterns of tax evasion behavior as it relates to the world of cryptocurrency (Cohn, 2021). Interestingly, the IRS has required taxpayers, for many years, to self-report cryptocurrency transactions on their tax returns with little success. As a result of the stepped-up focus on crypto transactions, the apparent game of "hide and seek" played throughout the crypto world is coming to a close and the resulting tax consequences are beginning to loom large. Unfortunately, the IRS grasp does not extend at the moment beyond the US coastline. There is concern that many crypto investors will merely relocate to the secret world of offshore tax havens and continue to evade the tax implications of cryptocurrency. For example, if a taxpayer relocates to Puerto Rico, capital gains transactions are 100% tax-free which would include cryptocurrency transactions (Smith, 2019). Whether the crypto tax evaders will be successful in transferring massive amounts of crypto assets offshore remains uncertain. Lately, countries like Switzerland have been required to disclose to the US government the names of American clients who are banking in their financial institutions in an attempt to further restrict foreign tax evasion options (Steverman, Ballentine and Moore, 2021).

4. Cryptocurrency Tax Basics

The IRS applies the IRC Sec. 61 (a) (3) when addressing their authorization to oversee cryptocurrency transactions (Turrin, 2021). The IRC guidance requires taxpayers to report, as gross income, all worldwide income regardless of the source. The 2021 tax return will continue to mandate that taxpayers self-report any cryptocurrency transactions at the top of their 1040 tax form. Additionally, the IRS requires that taxpayers report any crypto transactions on form 8949. Form 8949 will provide the taxpayer with the required steps to follow in the calculation of any reportable capital gains or losses (Royal, 2021). The short-term capital gains rate is the same as ordinary income rates but, the long-term capital gains tax rates range from 0%-20% as determined by a taxpayer's ordinary tax rate. Interestingly, the IRS recently narrowed the reporting

requirement by excluding any taxpayer who purchased virtual currency with real currency from answering yes on their 1040 form. Additionally, the IRS does not exclude taxpayers from reporting transactions merely because they did not receive a 1099 form from their broker. Furthermore, the IRS has determined that any inherited cryptocurrency will be treated the same as any inherited property and will only be subject to estate taxes if the value of the estate exceeds the IRS taxable threshold of $11.7 million in 2021. Similarly, cryptocurrency gifts are subject to the same tax rules as any gift and will only be subject to a gift tax once the value of the crypto gift exceeds $15,000 in 2021. The federal tax rates for 2021 for capital gains according to the IRS are as follows:

Table 1: Long-Term Capital Gains Rates

Tax Rate	Single Income	Married Filing Jointly Income	Head of Household Income
0%	$0-$40,400	$0-$80,800	$0-$54,100
15%	$40,401-$445,850	$80,801-$501,600	$54,101-$473,750
20%	>$445,850	>$501,600	>$473,750

Short-Term Capital Gains Rates = Ordinary Income Tax Rates

Tax Rate	Single Income	Married Filing Jointly Income	Head of Household Income
10%	$0-$9,950	$0-$19,900	$0-$14,200
12%	$9,951-$40,525	$19,910-$81,050	$14,201-$54,200
22%	$40,526-$86,375	$81,051-$172,750	$54,201-$86,350
24%	$86,376-$164,925	$172,751-$329,850	$86,351-$164,900
32%	$164,926-$209,425	$329,851-$418,850	$164,901-$209,400
35%	$209,426-$523,600	$418,851-$628,300	$209,401-$523,600
37%	>$523,600	>$628,300	>$523,500

5. Conclusion

The IRS attempted to deal with the problematic taxation of virtual crypto transactions in Notice 2014-21, which provides that cryptocurrency be treated as property for federal tax purposes (Lerer, 2019). As a result of that guidance, taxpayers must recognize capital exchange gains or losses on the trades or barters of cryptocurrency for cash or other property (Lerer, 2019). According to the IRS, the sale or other exchange of virtual currencies, or the use of virtual currencies to pay for goods or services, or holding virtual currencies as an investment, generally has tax consequences that could result in tax liability. The current inaccurate view held by many in the world of crypto transactions, that these transactions fall outside the radar of the Internal Revenue Code is quickly being rectified by additional IRS guidance. The IRS is attempting to institute regulatory guidance that would better provide for the accurate reporting and fair taxation of any virtual crypto transaction. Unfortunately, the current IRS guidance creates a landscape of tax compliance uncertainty creating an opportunity for the unintended consequences of creative crypto tax avoidance strategies.

References

Aued, A. (2021). Crypto assets, money laundering and tax evasion: Focusing more accurately, https://www.ciat.org/ciatblog-crypto-assets-money-laudering-and-tax-evasion-focusing-more-accurately/?lang=en

Ashford, K. & Schmidt, J. (2020). What is Cryptocurrency? https://www.forbes.com/advisor/investing/what-is-cryptocurrency/

Baker, C. W. & McKinney, Jr, R. (2021). Cryptocurrency and Federal Tax Enforcement, https://www.americanbar.org/groups/business_law/publications/blt/2021/06/fed-tax-enforcement/

Cohn, M. (2021). IRS turns to data analytics to track crypto tax evasion, https://www.accountingtoday.com/news/irs-turns-to-data-analytics-to-track-crypto-tax-evasion

Gilman, F. (2021). Confused About Bitcoin as I am, some answers to questions https://www.newsweek.com/confused-about-bitcoin-as-i-am-answers-to questions-opinion

Kelleher, J. (2021). Why Do Bitcoins Have Value? *https://www.investopedia.com/ask/answers/100314/why-do-bitcoins-havevalue.asp*

Lerer, M. (2019). The Taxation of Cryptocurrency, in CPA Journal, https://www.cpajournal.com/2019/01/24/the-taxation-of-cryptocurrency/

Planes, A. (2021). Over the Top Crypto Play Isn't a Token, https://www.motleyfoll.com/over-the-top-crypto-play-isn't-a-token/

Royal, J. (2021). Cryptocurrency taxes: A guide to tax rules for Bitcoin, Ethereum and more, https://www.bankrate.com

Smith, K. (2019). How Crypto Could Bring Tax Evasion to the Masses, https://www/onezero.medium.com/how-crypto-could-bring-tax-evasion-to-the-masses-bb4060766147

Steverman, B., Ballentine, C. & Moore, D. (2021). Crypto Investors Get Ready for More Taxes-but Clearer Rules, https://www.bloomberg.com/news/articles/2021-07-31/taxes-on-bitcoin-congress-pushes-to-make-sure-traders-report-pay-ins.

Turrin, M. (2021). Key Cryptocurrency Tax Issues, https://calvettiferguson.com>Insight