CHALLENGED BY NEW CRYPTOCURRENCY TAX RULES? TAXBIT HAS THE ANSWERS

Businesses, taxpayers, digital asset exchanges, and the Internal Revenue Service (IRS) itself are impacted by new requirements for reporting cryptocurrency and other digital asset transactions to the IRS. The requirements became law in the Infrastructure Investment and Jobs Act and go into effect in tax year 2023.

The new requirements include:

- Increased Form 1099 reporting for individuals transacting digital assets, including cost-basis and transfer information
- New Form 8300 reporting requirements for businesses accepting payments of $10,000 or more in digital assets

The new requirements will require significant operational changes for exchanges and the IRS, and they will make it easier for taxpayers to fulfill their tax obligations.

TAXPAYERS AND THE NEW CRYPTO-REPORTING RULES

The IRS considers digital asset investments to be property, and since 2014 it has required capital gains reporting for individuals and entities transacting in cryptocurrency. But many taxpayers have not understood their tax obligations. They are not trying to cheat on their taxes or hide from the IRS – and in fact, they cannot (more about this later).

As cryptocurrency business adviser and Harvard Business School economist Scott Duke Kominers explained: "A lot of people would like to pay taxes on their crypto but have absolutely no idea how to do so. … Organizing the tax treatment of all these assets – and then, of course, ensuring tax payment – is essential."

With the new requirements, Congress and the IRS are enabling electronic filing for digital asset transactions, just as they did for equities only 12 years ago. In other words, what is happening now is not a new idea or process – the reporting of digital asset transactions is just catching up to other investment reporting requirements. As a result of the new digital asset reporting requirements, the IRS will fill a “tax gap” by making it much easier for taxpayers to fulfill their tax obligations. That tax gap is expected to fund $28 billion in expenditures under the infrastructure bill.

> 16 percent of U.S. adults say they personally have invested in, traded, or otherwise used a cryptocurrency
>
> - Pew Research Center survey, September 2021

THE CURRENT CRYPTO-REPORTING CONUNDRUM

Since 2014, taxpayers have shouldered a heavy burden as they try to report transactions accurately to the IRS. That is because digital asset exchanges haven not been required to report transactions directly to the IRS or to taxpayers. Section 80603 of the infrastructure bill requires digital asset brokers to report any digital asset transactions, including transfers.

To better understand the current reporting burden on taxpayers investing in digital assets, let us look at the current equities reporting process in comparison to digital asset reporting. Here is how capital gains and losses on equities are reported:

1) Brokers and barter exchanges record gains and losses during a tax year on IRS Form 1099-B and provide that form to their customers at the end of the tax year
2) Taxpayers record that information on IRS Form 8949 and calculate their preliminary gains and losses on Form 8949
3) Taxpayers enter the resulting calculation on Schedule D of their tax return

And here is how capital gains and losses on digital assets are reported:

- Some digital asset exchanges do not report transactions to their customers via IRS forms, leaving the entire tax reporting process to their customers
- Other digital asset exchanges report transactions to their customers via one of the IRS forms outlined below

Tax Form	Data Reported
1099-MISC	Gross income from cryptocurrency rewards or staking, recorded as “other obligation”
1099-K	Total value of digital assets bought, sold, or traded on an exchange. Issued to consumers with more than 200 transactions and $20,000 in gross proceeds
1099-B	Gains and losses from individual transactions, in aggregate

No matter which forms they receive, taxpayers have a lot more work to do. Here is why:

1) Form 1099-MISC reports total income, not capital gains or losses
2) Form 1099-K reports receipts, but the amount on this form does not equate to capital gains or losses
3) Form 1099-B reports gains and losses from individual transactions, but in aggregate

None of the forms detail individual transactions, which the IRS requires, and they do not record capital gains and losses in a way that meets IRS requirements for digital asset reporting. Taxpayers must rely on their own detailed records to complete IRS Form 8949 and Schedule D. Even then, they may receive a warning letter from the IRS because the current disarray of reporting methods.

The new requirements seek to simplify the reporting process for everyone by ensuring that exchanges are gathering and submitting the right information to the IRS and taxpayers via a single form. While the current expectation is that exchanges will report transactions via Form 1099-B, TaxBit believes the IRS ultimately will develop a form that is specific to digital asset transactions, potentially called 1099-DA.

EXCHANGES AND THE NEW CRYPTO-REPORTING RULES

Exchanges need to prepare now to meet the new reporting requirements. Operational changes they need to make include:

- Tracking the holding period and the buy and sell prices of the digital assets in customer accounts
- Collecting personal information from taxpayers via IRS Form W-9 (for U.S. citizens and resident aliens) or Form W-8 (for foreign persons and businesses). That personal information includes name and address, as well as taxpayer identification number (TIN). This information will be used to generate Form 1099-B (or a future, digital asset-specific form)
- Validating TINs with the IRS

Exchanges that have not collected and verified personal information will be required to do so during the onboarding of new customers. They will also need to engage with existing customers to obtain their information and validate it.

The collection of personal identifying information (PII) and the requirement to provide Forms 1099 for taxable events will be a sizeable shift for decentralized digital asset platforms (DeFi), which facilitate transactions fueled through smart contracts in which the sender and recipient can remain unidentified.

It is important to note that with identity verification, digital asset transactions are not anonymous, it is difficult to be completely anonymous transacting on a blockchain. Each asset is associated with a customer, and every transaction leaves a digital footprint that is that connected back to that customer – even when the customer takes digital assets offline and holds them personally. When offline assets are reloaded to an exchange, the movement is recorded digitally as well.

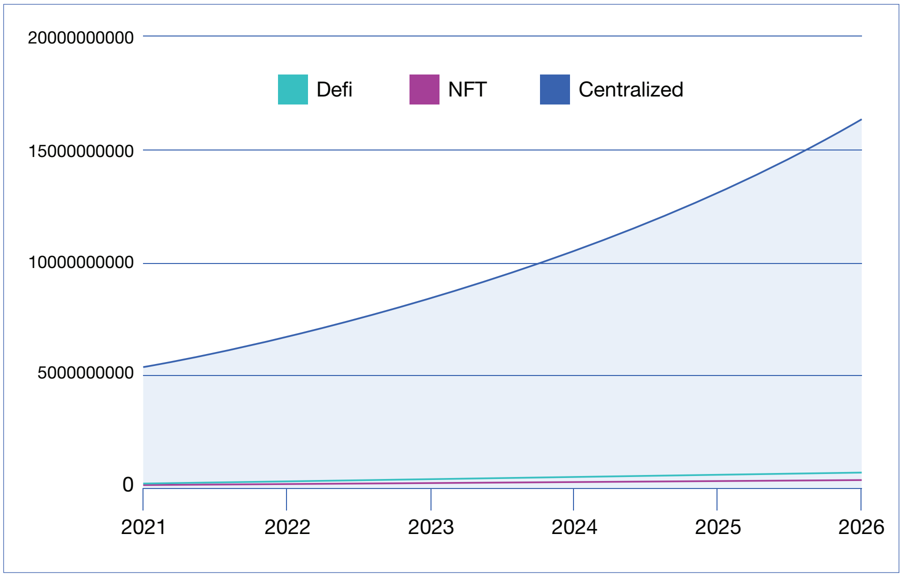
KYC

Know Your Customer
The personal information outlined here is the baseline of extensive Know Your Customer (KYC) requirements that apply to the banking industry. While the digital asset industry is not required to implement KYC, some exchanges already do so, and some governing bodies want to make it mandatory.

THE IRS AND THE NEW CRYPTO-REPORTING RULES

The IRS is in the process of preparing its personnel and its information systems for a huge influx of complex digital asset transaction data beginning with 2023 tax filings. TaxBit estimates the 2021 annual volume of U.S. digital asset transactions at 5.37 billion. We estimate this number will grow to 8.39 billion by 2023.

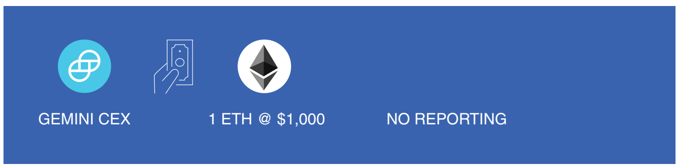
Year	Defi	NFT	Centralized	Sum
2021	109,114,440	106,957,758	5,153,631,000	5,369,703,198
2022	136,393,050	133,697,198	6,442,038,750	6,712,128,997
2023	170,491,312	167,121,497	8,052,548,438	8,390,161,246
2024	213,114,140	208,901,871	10,065,685,547	10,487,701,558
2025	266,392,675	261,127,339	12,582,106,934	13,109,626,947
2026	332,990,844	326,409,174	15,727,633,667	16,387,033,684



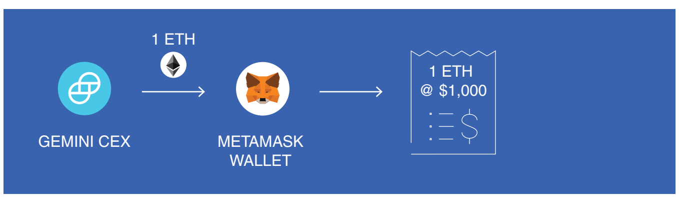
Growth Rate 25%

The IRS will grapple not only with transaction volume, but also with data complexity. Here is an example of the transactions that occur when a digital asset moves from a cryptocurrency exchange to an unhosted wallet to a DeFi Platform, then back to an unhosted wallet and to a cryptocurrency exchange, as well as the reporting that occurs under current requirements:

1/1 – Aaron buys 1 Ether (ETH) at a cost basis of $1,000 on cryptocurrency exchange Gemini. There is no reporting event.

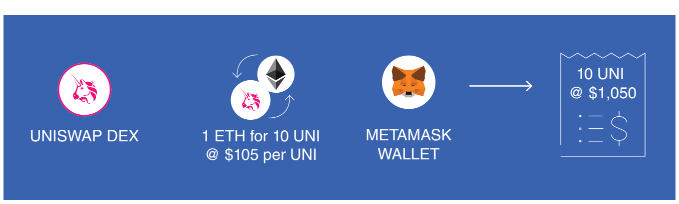


1/2 – Aaron transfers 1 ETH from Gemini to unhosted wallet Metamask. Gemini produces a transfer statement and sends the ETH to Metamask, showing Aaron's cost basis in the 1 ETH at $1,000.

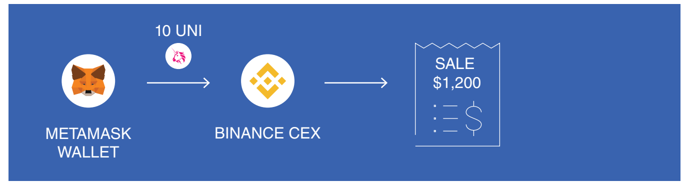


Aaron uses Uniswap, a DeFi Platform, to sweep funds from Metamask to execute a trade of his 1 ETH for 10 Uniswap (UNI) at a price of $105 per UNI. Because Metamask isn't a broker in this case, it is not responsible for passing the transfer statement to Uniswap. As such, Uniswap doesn't know Aaron's cost basis in the 1 ETH and would report proceeds on the trade of $1,050 and leave the cost basis null on Aaron's 1099.

However, Uniswap would issue Metamask a transfer statement because it swept the ETH from Metamask to make the trade and then swept the newly acquired UNI back to Metamask. That transfer statement would show Aaron's cost basis in the 10 UNI at $1,050.



1/4 – Aaron transfers 10 UNI from Metamask to cryptocurrency exchange Coinbase. As an unhosted wallet, Metamask isn't responsible for passing the transfer statement to Binance. As such, Binance doesn't know Aaron's cost basis in the 10 UNI and would report proceeds on the sale at $1,200 and leave the cost basis null on Aaron's 1099.



The infrastructure bill clarifies that brokers must report trades and transfers of digital assets on Form 1099-B. This is a step toward simpler cryptocurrency tax accounting. However, the new requirements are unlikely to capture every transaction, as the example above demonstrates. Customers will need to keep meticulous records, and the IRS must understand where gaps in reporting will occur, and why.

TAXBIT CAN FULFILL CRYPTO TAX ACCOUNTING REQUIREMENTS TODAY

The IRS is already increasing its cryptocurrency accounting capability. In May 2021 the agency contracted with TaxBit for support in evaluating cryptocurrency transactions. TaxBit's digital asset tax and accounting software is used by enterprises, consumers, and government entities. Under the IRS contract, TaxBit will analyze IRS data to help the agency verify the scope and accuracy of crypto tax reporting, focusing on high-volume transactions..

TaxBit will use its software-as-a-service platform to aggregate and normalize data reported to the IRS via multiple exchanges and wallets. The platform will then automatically calculate the cost basis and gains or losses on every transaction. TaxBit will verify that all reportable transactions are filed with the IRS. TaxBit's reports to the IRS will also be provided to taxpayers.

The TaxBit platform was built by certified public accountants, tax attorneys, and developers to drive mainstream adoption of digital assets by connecting the consumer, enterprise, and government tax and accounting ecosystems. It is trusted by thousands of consumers, leading exchanges and enterprises, government agencies, respected accounting firms, and others to solve complex accounting problems at scale and ensure compliance with the latest tax laws.

TaxBit anticipated that required compliance and reporting for digital assets would eventually align with traditional broker reporting, and for several years has helped many of the leading cryptocurrency exchanges properly issue Forms 1099-B. Now we are helping the IRS increase its capability to handle large volumes of digital asset data and ensure accurate tax reporting. Crypto tax compliance is possible today with TaxBit.

To learn more, visit taxbit.com/government.