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Crypto Crackdown: Information Reporting in a Digital Asset World

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The interplay of increased IRS enforcement capabilities with respect to crypto assets, a delayed effective date for new broker reporting rules, and new proposed regulations on the horizon has left many taxpayers feeling thankful for the reprieve, yet apprehensive of what lies ahead. For a long time, there had been little guidance in this area, with most taxpayers unclear on what to do with information related to digital assets. Now, as brokers await proposed regulations that are due to be issued any day now, they also wonder what additional processes are in store. In addition, recent legislative challenges and executive proposals seek to refine the reporting process. Thus, while it is clear that there will be a crackdown on crypto reporting, the question is when and what form(s) it will take.

Background

Although a deep dive into the history of crypto assets is beyond the scope of this tax blog, it is worth noting that the IRS did not issue significant guidance on virtual currencies until five years after Bitcoin, the largest cryptocurrency by market capitalization, was created. In the early years, it was unclear whether virtual

currencies should be categorized as a currency¹ or an asset. IRS Notice 2014-21,² outlined certain challenges in dealing with virtual currencies, but confirmed that they should be treated as property, subject to taxation in line with other property transactions. As stated in the Notice, taxpayers that receive virtual currencies as payment for goods or services should include the fair market value of the virtual currency when computing gross income, and report gains accordingly. The IRS also addressed the need to report payments for services on Form 1099-MISC, and the requirement to report payment settlements using virtual currencies on Form 1099-K. The IRS left a number of issues open but requested that taxpayers submit comments for consideration for future guidance.

Cryptocurrency use expanded exponentially over the years, leading to new coin offerings and transaction methods. In 2018, the same year that cryptocurrency was added to the dictionary, the IRS Information Reporting Advisory Committee (IRPAC) addressed the rise of its popularity in the 2018 Public Report.³ Citing outside research, IRPAC noted that the cryptocurrency market had grown from \$19 billion to \$500 billion, in just one year. IRPAC estimated a noncompliance rate of 50% due to the difficulty in tracing virtual currency transactions, resulting in a U.S. tax gap of \$458 billion. The Public Report stated that Notice 2014-21 was instrumental in setting general principles for the treatment of cryptocurrencies, but fell short in defining when and how reporting should occur. Thus, IRPAC called on the IRS to continue to develop guidance for information reporting and withholding on cryptocurrencies, notably asking whether broker reporting should be required.

Expanding broker information reporting

In May 2021, the White House released its annual *Budget of the U.S. Government* for Fiscal Year 2022 (FY2022 Budget),⁴ which contained a single line item titled “Expand broker information reporting with respect to cryptocurrency assets.” Oddly, the budget indicated there would be no deficit increases or decreases for this proposal. Shortly thereafter, Treasury released *General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals*, informally referred to as the Green Book (FY2022 Green Book).⁵ As detailed in the Green Book, the Administration had become increasingly concerned about offshore tax evasion through the use of crypto assets. The Green Book stated that the U.S. could combat this issue through cooperation with its global network of information exchange partners, but needed to increase third party information reporting in order to reciprocate useful information. To that extent, the proposal sought to expand the scope of information that was reported by brokers involved in crypto asset transactions, including crypto asset exchange entities and wallet providers.

The Infrastructure Bill

In November 2021, Congress enacted the Infrastructure Investment and Jobs Act of 2021 (the Infrastructure Bill),⁶ a \$1.2 trillion spending package to fund transportation, broadband, water, and electrical improvements. Included as a revenue offset, the Infrastructure Bill contained an information reporting section to amend sections 6045 and 6045A for broker reporting of digital assets. Notably, it expanded the definition of “broker,” defined “digital assets,” and classified digital assets as a “specified security” that would be subject to cost basis reporting. Amendments under the Infrastructure Act required brokers to report digital asset transfers to both brokers and non-broker addresses and required businesses to report more than \$10,000 in value of digital assets received as part of their trade or business. However, language under the amendments gave rise

¹ Interestingly, the first use of Bitcoin was a test case by an early adopter to see if anyone would bring him pizza in exchange for the new currency. The exchange was successful - 10,000 Bitcoin for two pizzas, valued at \$41 in 2010, but \$680 million at its peak in 2021. For more information, see <https://www.marketwatch.com/story/bitcoin-pizza-day-laszlo-hanyecz-spent-3-8-billion-on-pizzas-in-the-summer-of-2010-using-the-novel-crypto-11621714395>.

² See Notice 2014-21 at <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

³ See the IRPAC 2018 Public Report at <https://www.irs.gov/pub/irs-pdf/p5315.pdf>.

⁴ See the FY2022 Budget at https://www.whitehouse.gov/wp-content/uploads/2021/05/budget_fy22.pdf.

⁵ See the FY2022 Green Book at <https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf>.

⁶ See the Infrastructure Act at <https://www.congress.gov/bill/117th-congress/house-bill/3684/text>.

to later issues. For example, the term broker was defined very broadly to mean “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.” Following passage of the act, industry participants voiced concerns that this provision was overly broad and could bring into scope certain non-custodial actors within the crypto ecosystem, such as blockchain validators, sellers of hardware and software wallets and software protocol developers. This generated legislative pushback (discussed below). The expanded reporting requirements were set to become effective beginning on January 1, 2023.

Throughout 2022, industry experts lobbied for changes, with some bipartisan attempts to pass legislation amending the law. However, there was very little traction to these complaints, as the year closed in on holiday shutdowns without meaningful modifications or guidance. However, on December 23, the IRS published Announcement 2023-2,⁷ stating that Treasury and the IRS intend to issue regulations to address the application of the Infrastructure Act amendments to digital assets. The Announcement provides taxpayers transitional relief until the regulations are finalized, allowing brokers to continue reporting gross proceeds and furnishing statements under the rules as they existed before the Infrastructure Act. In addition, brokers are not required to report or furnish additional information for the disposition of digital assets under section 6045, issue additional statements under section 6045A, or file any returns with the IRS on transfers of digital assets under section 6045A(d). Shortly thereafter, the Office of Management and Budget’s (OMB) Office of Information and Regulatory Affairs (OIRA) posted an update on its webpage that Treasury and the IRS had submitted proposed regulations for review.⁸ Although the OIRA description provides very little information, it states that the regulation will also provide guidance under section 6050W regarding the reporting obligations of brokers who are also third-party settlement organizations. As of March 13, 2023, there has been no movement, but the proposed regulations are expected imminently, at which point the IRS will likely request public feedback for consideration before finalizing the regulations.

Legislative Challenges

In November 2021, a bipartisan group of House Representatives introduced H.R. 6006,⁹ a bill to amend certain digital asset information reporting requirements under the Infrastructure Act. Titled the *Keep Innovation in America Act*, the primary change was to limit those taxpayers that are required to report. The Infrastructure Act expanded the definition of brokers that are required to report to “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.” However, as noted above, this overly broad definition led to significant concerns that crypto participants not involved in digital asset transactions would be subject to reporting. As noted in the Findings section of H.R. 6006, “Miners and validators, hardware and software developers, and protocol developers are not actual brokers and do not collect or have reason to collect the information required under the” Infrastructure Act. To that extent, the bill sought to amend the statutory definition of broker to include “any person who (for consideration) stands ready in the ordinary course of a trade or business to effect sales of digital assets at the direction of their customers.” Thus, this language severely curtails the number of crypto participants subject to reporting.

In addition, H.R. 6006 sought to reduce the authority of Treasury to extend reporting requirements by removing a phrase which permits the Secretary to further define digital assets or similar technology subject to reporting. The bill also mandated that information reported on the transfer of digital assets be limited to that which was voluntarily provided by a customer and held by the broker for a legitimate business purpose. It is unclear whether a taxpayer would be able to simply bypass reporting by refusing to voluntarily provide certain information. Finally, the bill called for all reporting to be postponed until 2025, reportable on 2026 information returns. The bill ultimately stalled out after being referred to the House Committee on Ways and Means.

⁷ See Announcement 2023-2 at <https://www.irs.gov/pub/irs-drop/a-23-02.pdf>.

⁸ See the OIRA webpage at <https://www.reginfo.gov/public/do/eAgendaViewRule?publd=202210&RIN=1545-BP71>.

⁹ See H.R. 6006 at <https://www.congress.gov/bill/117th-congress/house-bill/6006?s=1&r=55>.

However, on March 9, 2023, H.R. 1414¹⁰ was introduced, containing nearly identical language as the 2021 version.

In June 2022, Senators Lummis and Gillibrand introduced S. 4356,¹¹ titled the *Lummis-Gillibrand Responsible Financial Innovation Act*, which sought to further regulate digital assets. Unlike the House bills above, S. 4356 was not focused on information reporting, rather, the comprehensive bill sought to delineate digital asset duties between the Securities and Exchange Commission (SEC) and the Commodity Future Trading Commission (CFTC). Included within the voluminous text were amendments to the information reporting provisions that were nearly identical to the House bills. The notable exception was that digital asset was more thoroughly defined via a cross-referenced section as a natively electronic asset that confers economic, proprietary, or access rights or powers, and is recorded using cryptographically secured distributed ledger technology. This includes virtual currency and ancillary assets, payment stablecoins, and any other security or commodity that meets the definition. The bill went to the Committee on Banking, Housing, and Urban Affairs in November 2022, but did not progress. Recent reports indicate that the pair of Senators are seeking to revive the bill this year.

Executive Proposals

As noted above, information reporting for digital assets first appeared in the FY2022 Green Book. On March 9, 2023, the White House issued the FY2024 *Budget of the U.S. Government* (FY2024 Budget),¹² which contained a number of digital asset information reporting line items. Notably, the FY2024 Budget included a new digital asset wash sale provision (expected to raise \$23.5 billion over 10 years), as well as digital asset broker reporting for purposes of exchange of information and reporting for foreign digital asset accounts (combined, expected to raise \$3 billion over 10 years).

Later the same day, Treasury issued *General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals* (FY2024 Green Book).¹³ The FY2024 Green Book detailed issues with the current treatment of digital assets, stating that the latest updates to wash sale rules are outdated in light of the new types of financial instruments that have been developed. Under the Green Book proposal, digital assets held as investments would be subject to the same loss recognition rules as stocks and securities, with applicable related party rules in place as well. The proposal also notes that wash sale rules will need to be amended to address derivative financial instruments more comprehensively. Under the proposal, broker reporting rules would also need to be amended to reflect changes to the wash sale rules. To address the inherent discrepancies between wash sale rules and cost basis reporting rules,¹⁴ the Green Book grants Treasury wide latitude to determine what reporting is necessary to implement the proposed wash sale rules and prevent abuse.

The FY2024 Green Book also elaborated on proposals first seen in the FY2022 Green Book, notably the ability of the U.S. to leverage its global network of exchange partners. Treasury points to the success of the FATCA program, but admits that the reciprocal exchange networks have been one sided. Under the proposal, these exchange agreements would be broadened to include digital assets. However, domestic reporting would be expanded to ensure that the IRS is able to collect and reciprocate the automatic exchange of information that is already occurring. Treasury would be granted broad powers to ensure domestic financial institutions capture and report certain information of non-U.S. payees, such as the account balance for all financial accounts maintained at a U.S. office and held by foreign persons.

¹⁰ See H.R. 1414 at <https://www.congress.gov/bill/118th-congress/house-bill/1414/text?s=1&r=1>.

¹¹ See S. 4356 at <https://www.congress.gov/bill/117th-congress/senate-bill/4356/text>.

¹² See FY2024 Budget at https://www.whitehouse.gov/wp-content/uploads/2023/03/budget_fy2024.pdf.

¹³ See FY2024 Green Book at <https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf>.

¹⁴ For a detailed discussion of reporting gaps between wash sale rules and cost basis reporting requirements, see *A Primer on Wash Sale Reporting in a Volatile Market* at <https://tax.kpmg.us/content/dam/tax/en/pdfs/2022/primer-wash-sale-tmm-092622.pdf>.

Finally, the Green Book proposal would expand reporting under section 6038D to include foreign digital asset accounts. Under current law, taxpayers are required to submit Form 8938, *Statement of Specified Foreign Financial Assets*, when they have an annual aggregate value of \$50,000 or more in a) financial accounts maintained by a financial institution, and b) certain specified assets not held in a financial account maintained by such a financial institution. However, Treasury notes that the global nature of the digital asset market is ripe for abuse, allowing taxpayers to conceal assets and taxable income by using offshore digital asset exchanges and wallet providers. Per the proposal, a third asset category would be added to the reporting requirements, requiring taxpayers to include amounts held in digital asset accounts when determining whether the aggregate threshold of \$50,000 applies. Thus, the proposal seeks to reduce offshore tax evasion through digital asset use by expanding and combining self-reporting under section 6038D and reporting by foreign financial institutions under FATCA.

Crypto Asset Reporting Framework (CARF)

In discussing all of these legislative challenges and executive proposals from a United States perspective, it is important to remember that the Organisation for Economic Co-operation and Development (OECD) continues to march forward with the CARF. This framework defines the relevant crypto assets in scope and those subject to reporting. The OECD intends for the CARF to function in the same way as the Common Reporting Standard (CRS), by exchanging information on a global level, and is set to become effective on January 1, 2026.

Going Forward – Reporting in 2023 and Beyond

Heading into 2023, it is safe to say that the world is moving toward increased enforcement related to crypto assets. Until recently, there was little guidance as to how reporting would look. While it is clear that changes are coming to Forms 1099-B and transfer statements, what remains unclear is what form those will take. Conflating the issue, the OIRA webpage alludes to additional Form 1099-K reporting, but without further context. The bipartisan House and Senate bills indicate that Congress is united in its stance that further amendments are needed, yet no action has occurred. Finally, the FY2024 Green Book opens up a wider realm of information reporting, proposing broader cost basis reporting, expanded FATCA reporting (domestically and internationally), and additional reporting for U.S. individuals. At this point, it is unclear which direction digital asset reporting will take, but changes are on the horizon and quickly approaching.

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