LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What The Inflation Reduction Act Has To Do With Crypto

By **John Reed Stark** (September 6, 2022, 4:26 PM EDT)


John Reed Stark

The recently enacted Inflation Reduction Act is primarily aimed at decreasing inflation, improving health care and managing climate change, but it also contains a proviso that will have a significant impact on the cryptocurrency marketplace: an $80 billion supplemental funding allotment for the IRS.

While there is some debate as to exactly how much of the $80 billion will go toward IRS audits and enforcement,[1] the supplemental appropriation was promoted as a means to generate revenue, which translates into increased enforcement efforts.

"By beefing up the IRS's capacity to go after wealthy tax cheats, you're going to be able to collect at least $400 billion of that over the course of the next ten years, and I suspect substantially more," Natasha Sarin, a counselor for tax policy and implementation at the U.S. Department of the Treasury, told NPR.[2]

While not quite as optimistic, increased IRS enforcement could generate $127 billion in new revenue over 10 years, according to the Congressional Budget Office.

Under any circumstance, the Biden administration is counting on beefed-up IRS enforcement efforts to help offset costs created by the $700 billion Inflation Reduction Act.[3] Thus, expectations around the $80 billion IRS budget boost are high, and the IRS will need to generate revenue — quickly and efficiently.

And what is the easiest and fastest way for the IRS to boost its revenue? Targeting crypto tax cheats.

Cryptocurrency and the Risk of Tax Evasion

Cryptocurrencies like bitcoin and ethereum have historically offered opportunistic ways to shield income from the IRS.[4] For instance, the U.S. tax laws require brokerage firms, mutual funds and other entities to report on Form 1099 all investment income, usually interest or dividends, they have paid to investors during the previous tax year.

But not necessarily so with unregistered cryptocurrency exchanges, platforms, etc., who may not be required to file Form 1099s reporting the crypto profits of their customers. Lee Reiners, who teaches fintech at Duke University School of Law, told me:

> It's the Wild West for some crypto traders. Crypto traders may believe that the federal

government is wholly unaware or otherwise oblivious to their crypto-related trading gains, and therefore may opt to conceal their profits and avoid paying any mandated capital gains taxes.

Along the same lines, cryptocurrency wallets — which are not typically federally regulated, inspected, examined, audited, etc. — have existed for years in a regulatory vacuum. Moreover, cryptocurrency traders can transact between private wallets in clandestine transactions, and because cryptocurrency is not always bought or sold through a cryptocurrency exchange, platform or wallet. In such off-the-grid trading situations, tax gains can become even more challenging to track, identify and analyze.[5]

Moreover, cryptocurrency can be used by criminals who are not likely to pay taxes on ill-gotten gains for fear of getting caught or merely in furtherance of their crimes.[6]

Crypto Traders Make Attractive IRS Audit Targets

For the IRS, there is a certain simplicity that makes investigating and prosecuting crypto traders especially appealing.

First off, the IRS already has powerful data points about crypto transactions. All filers must report cryptocurrency trading gains to the IRS. For instance, on the new 1040 Schedule 1, the IRS has put crypto front and center, high up on the first page of the tax return: "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"[7]

How a taxpayer may have come to possess cryptocurrency is of no consequence, and unlike most reporting of assets, IRS reporting of crypto holdings does not require a transaction. For taxpayers holding cryptocurrency, they are expected to tell the IRS about it.

Much like the foreign bank account question that appears on Schedule B to tax returns, which has undoubtedly led to civil and criminal penalties, new crypto-related 1099 reporting could spawn a similar wave of civil and even criminal prosecutions.

Second, the laws are clear.[8] The IRS considers crypto a property asset, therefore profiting from a crypto sale or from exchanging one crypto for another triggers a tax.[9]

Along those lines, in 2014, the IRS issued Notice 2014-21,[10] amplifying that cryptocurrency is treated as property for federal income tax purposes and providing examples of how long-standing tax principles applicable to transactions involving property apply to cryptocurrency. The IRS even issued a list of 46 frequently asked questions for crypto traders explaining the IRS position and making clear IRS expectations.[11]

The IRS John Doe Summons

The IRS has a broad array of investigative tools at its disposal to pinpoint cryptocurrency holdings and transactions. For instance, to determine traders' identities and trading histories, the IRS can send a John Doe summons to a crypto trading platform, exchange, wallet, etc.

A John Doe subpoena is quite an extraordinary investigative tool. With a federal judge's approval, the IRS can compel information from any type of cryptocurrency platform, exchange, wallet, etc., without identifying any particular person or even providing any sort of description. It's a classic case of "you don't know what you don't know," so courts can give the IRS carte blanche to compel production of the identities and trading information of anyone who profited during any period of time.[12]

Along these lines, the IRS petitioned for, and U.S. District Judge Otis D. Wright II **recently approved** an IRS John Doe summons on Ox Labs Inc., which does business as sFOX, to obtain information about certain unknown sFOX high-value users, including any U.S. person with at least $20,000 in transactions from 2016-2021.[13]

Clearly, the John Doe summons, a remarkably powerful IRS investigative contrivance, will become a critical tool to identify crypto traders and review their trading profits.[14]

Operation Hidden Treasure

The IRS has already stated its intention to use more John Doe summonses to track down cryptocurrency traders[15] and in March 2021, the IRS announced the launch of the aptly named Operation Hidden Treasure, an IRS enforcement initiative specifically designated for tax violations related to cryptocurrency.[16]

Operation Hidden Treasure is evidently already in full swing and the IRS has filed, and a federal court has approved, John Doe summonses against Circle Internet Financial Ltd.[17] and Payward Ventures Inc., or Kraken.[18]

The summonses were significantly broad on all fronts, seeking account information for any account with transactions totaling $20,000 or more from 2016-2020. For those accounts, the IRS demanded just about every document relating to the individual or company involved, seeking production of "account registration records, know-your-customer due diligence, account-related correspondence, anti-money laundering exception reports, records of account activity, and records of account funding."[19]

Notably, the Circle petition also sought records pertaining to Circle's predecessors, subsidiaries, divisions and affiliates, including Polonies LLC, which Circle purchased in 2018. U.S. District Judge Richard Stearns, who approved the John Doe summons, found that "[t]here is a reasonable basis for believing that cryptocurrency users may have failed to comply with federal tax laws."[20]

According to the court's order, the summons seeks information related to the IRS' "investigation of an ascertainable group or class of persons" that the IRS has a reasonable basis to believe may have failed to comply with any provision of any internal revenue laws.[21]

Whether the efforts of the Kraken and Circle John Doe summonses will bear fruit is not yet known. But with respect to **another** earlier John Doe summons to Coinbase in 2016, the IRS petition seeking a John Doe summons to sFOX provides a rather extraordinary update.

According to the IRS sFOX John Doe petition, in 2016, after a John Doe summons against Coinbase was approved, the IRS collected information about accounts from 2013-2015, and assessed more than $17.6 million based on unreported transactions, and $92 million for failing to file returns.[22]

The IRS showcases the Coinbase data in its sFOX John Doe summons petition as proof that its suspicions about crypto-related tax evasion had merit and that IRS efforts to track down and charge the individuals behind crypto-related tax evasion had borne fruit. And that evidence remains quite compelling.

A New Crypto Reporting Era Begins Jan. 1, 2024

Thanks to a quiet, and oddly incompatible,[23] provision of the Infrastructure Investment and Jobs Act, after Jan. 1, 2024, the IRS will have even more resources available to investigate crypto-related tax evasion, and become even fiercer in the coming years.

Specifically, the Infrastructure Act heightens IRS reporting requirements relating to cryptocurrency by expanding two of its traditional reporting forms — Form 8300 for certain persons who accept large payments in cryptocurrency in such person's trade or business, and Form 1099-B for cryptocurrency exchanges and custodians.[24]

Form 8300

Section 6050I[25] implemented mandatory financial transaction reporting obligations on IRS Form 8300, a joint IRS and Financial Crimes Enforcement Network form. Section 6050I was originally drafted to allow greater government surveillance of large cash transactions to curb illicit activities and help law enforcement combat money laundering, tax evasion, drug dealing, terrorist financing and other criminal activities.

But this reporting was typically reserved only for physical, in-person payments in cash exceeding $10,000.[26]

Fast-forward to 2022, and the Infrastructure Act now redefines cash to include "any digital representation of value" involving distributed ledger technology, such as blockchain, completely transforming the reporting triggers.

Thus, beginning Jan. 1, 2024, any person[27] who receives digital assets in the course of a trade or business with a value exceeding $10,000 in crypto who is in business must "collect, verify, and report a sender's personally identifiable information within 15 days." Failure to file a Form 8300 is a serious offense, and can trigger fines as well as criminal liability.[28]

Specifically, the information Form 8300 require includes:

- The identifying information of the individual from whom the cash was received, including such individual's name, address, occupation and taxpayer identification number;
- The identifying information of the person on whose behalf the transaction was conducted; and
- A description of the transaction and method of payment.[29]

The IRS' reach will be difficult to evade. Per tax legal expert Nancy Dollar:

> Any receipt of a digital asset is potentially reportable, regardless of dollar value, as receipts must be aggregated if related in a series of connected transactions. A new Form 8300 is required each time a payment results in an excess of the $10,000 threshold.[30]

Moreover, Dollar believes that using private keys offers no refuge from IRS scrutiny and enforcement:

> A taxpayer is presumably in receipt of digital assets whenever they become held in an account or at digital storage location in the taxpayer's control, for instance, through possession of private keys. Receipt occurs regardless of how long the assets are retained

and whether they are subject to a custodial arrangement.[31]

Form 1099-B

Historically, Form 1099-B is the form securities brokerage firms have used to report the sale of securities to the IRS. Now, as of Jan. 1, 2024, pursuant to the Infrastructure Act, cryptocurrency will be classified as securities that are subject to reporting on IRS Form 1099-B.

This means that brokerages must now report every transaction that the brokerage has enabled between the cryptocurrency buyer and the seller. The law also expands the definition of broker to target cryptocurrency exchanges, which now includes "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[32]

Digital assets are defined broadly as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology" as specified by the secretary of the Treasury.[33] Some experts believe that the definition is so broad because it is meant "to include any other representation of value that may be created, including non-fungible tokens."[34]

Looking Ahead

It appears that the IRS studied carefully the raw data collected from each of its crypto-related John Doe summonses and after engaging in some rudimentary data analytics, found compelling evidence of "likely large-scale underreporting of taxable transactions," according to the IRS John Doe petition of sFox, talking about the John Doe petition of Coinbase.[35]

According to the IRS, 800 to 900 taxpayers filed returns that included cryptocurrency tax payments each year between 2013 and 2015, even though "Coinbase alone had serviced more than 5.9 million customers and handled more than $6 billion in transactions during that time."[36]

Moreover, while the IRS did apparently discover some improvement in crypto-related tax reporting during the years 2017-2019, the evidence of compliance "still fell far short of what would be expected given the number of users, transactions, and value that the exchanges publicize occur on an annual basis."[37]

Undoubtedly, the IRS will continue to reach out to taxpayers engaged in cryptocurrency transactions regarding the reporting requirements, conduct examinations, issue John Doe subpoenas, seek large penalties, and make referrals to its criminal investigation division.

Armed with an $80 billion war chest, a clear mandate, strict liability statutes, sweeping investigative authority and powerful fact-finding tools, the IRS is on a high-tech mission to catch crypto tax cheats. So fail not at your peril crypto traders, the IRS wants you — big-time.

John Reed Stark is president at John Reed Stark Consulting LLC and a senior lecturing fellow at Duke University School of Law. He previously served for almost 20 years in the U.S. Securities and Exchange Commission's Division of Enforcement, the last 11 of which as chief of its Office of Internet Enforcement.

general information purposes and is not intended to be and should not be taken as legal advice.

[1] https://www.vox.com/2022/8/16/23302798/irs-audit-inflation-reduction-act; https://www.politico.com/news/2022/08/16/irs-spending-new-money-00051523.

[2] https://www.npr.org/2022/08/14/1117317757/irs-tax-evaders-dodgers-inflation-reduction-act-enforcement.

[3] https://www.crfb.org/blogs/cbo-estimates-120-billion-irs-funding-boost.

[4] It is not surprising that according to the U.S. Treasury, the crypto economy contributes significantly to the U.S. "tax gap" i.e. "the difference between tax paid and tax owed, which the U.S. Treasury estimates to be, in total, $7 trillion over the next decade." https://www.cnbc.com/2021/05/31/cryptocurrency-poses-a-significant-risk-of-tax-evasion.html; https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap.

[5] https://www.cnbc.com/2021/05/31/cryptocurrency-poses-a-significant-risk-of-tax-evasion.html.

[6] "Cryptocurrency already poses a significant detection problem by facilitating illegal activity broadly including tax evasion," according to a May 2021, U.S. Treasury report. That report outlined the Biden administration's tax-compliance agenda and recommended increased reporting by cryptocurrency traders and retailers to generate revenue by allowing for better pursuit cryptocurrency tax evaders. https://home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf.

[7] https://www.irs.gov/pub/irs-pdf/f1040.pdf.

[8] "Taxpayers who transact with cryptocurrency should understand that income and gains from cryptocurrency transactions are taxable," said Deputy Assistant Attorney General David A. Hubbert of the Justice Department's Tax Division in a recent DOJ press release. https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-2.

[9] https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.

[10] https://www.irs.gov/pub/irs-drop/n-14-21.pdf.

[11] https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.

[12] https://www.natlawreview.com/article/irs-mining-crypto-account-holders.

[13] https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-2.

[14] "The John Doe summons remains a highly valuable enforcement tool that the U.S. government will use again and again to catch tax cheats and this is yet one more example of that," said IRS Commissioner Chuck Rettig after the sFOX John Doe petition approval. "I urge all taxpayers to come into compliance with their filing and reporting responsibilities and avoid compromising themselves in schemes that may ultimately go badly for them." https://tax.thomsonreuters.com/news/federal-court-oks-john-doe-summons-in-cryptocurrency-

probe/.

[15] https://news.bloombergtax.com/daily-tax-report-international/irs-to-boost-use-of-john-doe-summonses-including-for-crypto.

[16] https://tax.thomsonreuters.com/blog/irs-launches-operation-hidden-treasure-and-the-implications-for-cpas/.

[17] https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1.

[18] https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1.

[19] https://www.natlawreview.com/article/irs-mining-crypto-account-holders.

[20] https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-0.

[21] https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/john-doe-summons-allowed-in-cryptocurrency-investigation/4lzd7.

[22] https://www.texastaxtalk.com/files/2022/08/SFOX-John-Doe-Summones-SD-NY.pdf.

[23] https://transportation.house.gov/committee-activity/issue/infrastructure-investment-and-jobs-act.

[24] https://www.ncsl.org/documents/statefed/IIJA-Section-by-Section.pdf; https://www.bdo.com/insights/tax/federal-tax/infrastructure-investment-and-jobs-act-contains-ne.

[25] https://www.law.cornell.edu/uscode/text/26/6050I.

[26] https://www.hansonbridgett.com/Publications/articles/2021-08-17-coders-brokers-crypto.

[27] Person is defined broadly and includes "an individual, company, corporation, partnership, association, trust or estate." https://www.irs.gov/pub/irs-tege/eotopici92.pdf.

[28] https://www.forbes.com/sites/robertwood/2021/12/13/crypto-irs-reporting-rules-promise--tax-compliance-and--enforcement/?sh=a5ab51c7ee1b; https://www.hansonbridgett.com/Publications/articles/211110-7200-crypto-compliance.

[29] https://www.irs.gov/businesses/small-businesses-self-employed/form-8300-and-reporting-cash-payments-of-over-10000).

[30] https://www.worldservicesgroup.com/publications.asp?action=article&artid=19962.

[31] https://www.worldservicesgroup.com/publications.asp?action=article&artid=19962.

[32] https://irc.bloombergtax.com/public/uscode/doc/irc/section_6045.

[33] https://www.forbes.com/sites/robertwood/2021/12/13/crypto-irs-reporting-rules-promise--tax-compliance-and--enforcement/?sh=a5ab51c7ee1b.

[34] https://www.berdonllp.com/update-crypto-investors-face-expanded-reporting-requirements/).

[35] https://www.taxnotes.com/research/federal/court-documents/court-petitions-and-briefs/irs-wants-to-serve-john-doe-summons-for-crypto-information/7dycb.

[36] https://www.texastaxtalk.com/files/2022/08/SFOX-John-Doe-Summones-SD-NY.pdf.

[37] https://www.texastaxtalk.com/files/2022/08/SFOX-John-Doe-Summones-SD-NY.pdf.