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TAXES

CPAs to Clients: The IRS is Coming for Cryptocurrency

As more people become interested in buying and selling digital assets, the IRS is ramping up its crypto tax enforcement efforts.

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By Tim Grant, Pittsburgh Post-Gazette (TNS)

Only a handful of Connolly Steel & Co. clients were dabbling in cryptocurrencies five years ago.

But the number of clients buying and selling cryptocurrencies—digital money that can be used in online transactions and theoretically cannot be governed by any centralized authority, such as a government—has grown to a point where the Avalon, PA-based accounting firm had to invest in software that keeps track of cryptocurrency trades for tax purposes.

“Most of our clients are dabbling in it through platforms like Robinhood Crypto,” said Elizabeth “Li” Connolly, a firm partner. “One client started actually mining cryptocurrency and bought special equipment to do so.”

Crypto mining operations—the process of creating new digital coins—have unique tax issues because the rules aren’t clear if miners are taxed as cryptocurrency investors or business owners.

“There’s different tax implications depending on the answer to that,” Ms. Connolly said.

This much is clear: As more people become interested in buying and selling digital assets like Bitcoin and Ethereum, the IRS is ramping up its efforts to collect taxes owed on digital transactions.

This can be a challenge—a big part of crypto’s appeal is that it’s decentralized, and hard for governments to track and tax.

But the digital currency is now in the crosshairs of agencies like the IRS, who are rolling out new strategies to make sure people involved in crypto are paying what they should.

For federal tax purposes, the IRS treats digital assets as “property,” and therefore transactions involving virtual currency are subject to the same general tax rules that apply to property transactions involving stock or real estate. The federal agency launched Operation Hidden Treasure in 2021, for example, to root out taxpayers who fail to report income from cryptocurrency transactions on their federal tax returns.

Also, the Inflation Reduction Act, enacted in 2022, allocated $80 billion to the IRS, with much of it designated for enforcement activities, including cryptocurrency monitoring.

And that's just the beginning.

The IRS's strategic operating plan for 2023 through 2031 lays out the agency's intention to ramp up enforcement action related to digital assets, according to Green Tree, PA-based accounting firm H2R CPA.

"The IRS is looking for unreported assets," said Lucas Rihely, a tax partner at H2R CPA. "That's really what the purpose of all this is."

Anonymous form of digital money transfers

You may have noticed a new line on your individual federal income tax return in recent years. The 2022 version asks taxpayers if they received any "digital assets" during the course of the year for payment or otherwise sold, exchanged or gifted any digital assets.

"In the first iteration of those questions, only a certain subset of taxpayers had to answer them, depending on whether they already had investment activity on their return," Mr. Rihely said. "Then, starting with the 2020 forms, every taxpayer who filed a Form 1040 needed to answer the question of whether they had received or sold crypto during the year."

Mr. Rihely said the terminology used by the IRS to ask the question also has evolved during the course of the years that it has asked the question.

"It started with 'virtual currency' being how crypto was referenced on the tax returns," he said.

With the advent of NFTs, the federal agency included them under the definition of property for tax purposes. NFTs also are included in the IRS question on tax forms related to digital assets.

NFTs are non-fungible tokens—which can represent digital or real-world assets like artwork and real estate on the blockchain. However, cryptocurrencies like Bitcoin have no individuality and can be replaced by tokens of the same kind.

Bitcoin and other cryptocurrencies essentially are an anonymous form of digital money transfer.

"From a use standpoint, cryptocurrency is a dollar bill," Mr. Rihely said. "When two people do a transaction with cash they have no other connection to each other after a transaction is done.

"There are myriad other ways that people look at crypto from a philosophical or an investment standpoint," he said. "But at its core its a way to anonymously pay someone and not have bank or credit card information tied to it. It's just an anonymous way to pay someone digitally that you would otherwise pay cash."

The IRS—and the courts—send a clear message

Stricter reporting requirements for crypto brokers will make it easier for the IRS to take a closer look at digital asset transactions.

The Infrastructure Investment and Jobs Act (IIJA), enacted in late 2021, created additional new reporting requirements for digital transactions that will provide the IRS with more information to keep an eye on taxpayers who engage in virtual currency transactions.

The IIJA expanded the definition of brokers that are required to report their customers' gains and losses on the sale of securities during the tax year—which includes a description of each sale, the cost basis, the acquisition and sale dates, prices, and the resulting loss or gain. That means operators of trading platforms for digital assets, such as cryptocurrency exchanges, are subject to the same reporting requirements as traditional securities brokers.

The effective date of the new reporting requirements hasn't been announced in light of the IRS not yet issuing final regulations with instructions.

The IIJA also amends existing anti-money laundering laws to treat digital assets as cash. Since the start of 2023, businesses are required to report to the IRS when they receive more than $10,000 in digital assets in one transaction or multiple related transactions.

Cryptocurrency transactions are meant to be harder—if not impossible—to trace.

But the IRS wields a powerful tool to uncover digital assets.

In a court case decided in May, the IRS issued a "John Doe" summons to obtain the cryptocurrency account information of a Coinbase customer—James Harper.

Mr. Harper alleged that he declared his Bitcoin transactions on his 2013 and 2014 tax returns and that he declared all "appropriate income from bitcoin payments," including capital gains tax.

Coinbase didn't comply with an IRS summons to produce the account information and Mr. Harper argued that the government request was unconstitutional.

But a U.S. District Court judge disagreed and ruled that the IRS's actions were "all squarely within its powers to pursue unpaid taxes."

With that decision—and other recent steps by the IRS—the message became clear:

The IRS is coming for crypto.

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