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More IRS crypto reporting, more danger

The U.S. authorities are becoming seriously interested in crypto, making unreported crypto more dangerous.

The United States Internal Revenue Service classifies crypto as property, meaning you can trigger taxes every time you use crypto to buy something. You might be using it to pay for a Tesla electric vehicle — oh, sorry, that's not possible anymore — a cup of coffee or even a castle in Europe. You might be paying someone for services, either as an independent contractor or as an employee. But no matter what the transaction, you may have a gain or a loss, something quite apart from the income tax impact on the person you are paying.

Not so simple with taxes

The tax impact might even be made more difficult by the wild fluctuations in value that tend to characterize crypto investments. Think about paying for services too: Say you pay someone as an independent contractor; to report the payment, you'll need to issue them an IRS Form 1099. Whatever the type or amount of crypto you use, the IRS will say you paid them the current market value of the crypto on that day.

When you pay an independent contractor and issue a Form 1099, you can't enter "1,000 Bitcoin (BTC)" on the form. You must put the value in U.S. dollars as of the time of payment. The contractor you pay might keep the crypto or might sell or transfer it the same day, but that doesn't impact your taxes.

How about wages paid to employees? Wages paid to employees using crypto are taxable and must be reported on a Form W-2. They are also subject to withholding and payroll taxes.

However, if you pay someone in property, how do you withhold taxes? You could pay some cash and some Bitcoin and withhold plenty on the cash, but that can be complex and messy. Of course, you could also opt for paying the person as a contractor. But remember, worker status issues can happen in any context, including this one.

Thus, investing and dealing in crypto inevitably involves significant tax issues, whether you like it or not. It is no secret that the IRS wants you to report your crypto gains. You can report crypto losses too, but the IRS does not care as much about whether you claim those. Income and gains, on the other hand, matter a lot to the IRS. The IRS still believes there are major compliance problems in the crypto community, so there's continuing distrust and extra scrutiny.

The scrutiny

The latest evidence of this continuing issue is that the U.S. Treasury Department expects to publish new rules saying businesses that receive crypto worth more than $10,000 would have to file a currency transaction report with the government naming names and giving details. You might think you won't get caught, but the risks are growing. The best way to avoid penalties, or worse, is to disclose and report as accurately as you can.

Remember those 10,000 letters sent by the IRS to crypto taxpayers? And how about all the IRS summonses to Coinbase, Kraken and others? The hunt is still on, as the crypto tax question on IRS Form 1040 should indicate. The Department of Justice's Tax Division successfully argued that the mere failure to check a box related to foreign bank account reporting is willfulness, per se; the same argument could get applied to crypto accounts.

Willful failures carry higher penalties and an increased threat of criminal investigation. The Criminal Investigation Division of the IRS has met with tax authorities from other countries to share data and enforcement strategies about cryptocurrency tax evasion.

When you file your taxes, the IRS asks a simple question: “At any time during 2020, did you receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?” It sounds pretty simple, yes or no, right? What could go wrong? It’s not asking for any numbers or details — although if you sold some, it should go elsewhere on your tax return. After all, since crypto is property to the IRS, any sale will produce either a gain or loss. Many other transfers will as well, even a swap of one type of crypto for another. The latest step was the announcement that the Treasury Department plans to impose new reporting requirements for crypto.

Soon, banks and financial institutions will have to report information to the IRS. Exchanges, custodians and crypto payment services are slated to have to do the same. Curiously, the government is taking pages of its playbook from the rules surrounding cash transactions, even though the IRS said way back in 2014 that crypto was property, not currency.

For cash, reports go on IRS Form 8300 for payments of over $10,000. The IRS even has a list of FAQs regarding reporting cash. For many years, businesses have been required to report cash payments of more than $10,000, which has prompted all sorts of (usually ill-advised) behavior by people to try to avoid doing so. So-called “structuring transactions” can be a crime, even if all the cash you are trying to use is entirely yours.

Therefore, if the $10,000 baseline is implemented for crypto reporting, my guess is there will be people trying to keep something private who end up in trouble for trying to sidestep a reporting trigger. The Bank Secrecy Act requires financial institutions to report currency transactions above $10,000 to the IRS. This law also makes it a crime to structure currency transactions to avoid the reports. The IRS Criminal Investigation Division enforces the rules on cash transactions.

Yet, a 2017 report said that the law is enforced primarily against individuals and businesses whose income was obtained legally. That’s what happened to former House Speaker Dennis Hastert, who was indicted over structuring his own money. Eventually, he was sentenced to 15 months in prison. Could crypto enforcement end up the same way?

If the new crypto reporting threshold of $10,000 goes the same way as cash reporting has, some people may try to structure around the reporting. If they do, and if the rules are similar to the cash reporting rules, that could be quite dangerous.

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