New Crypto Reporting Will Require Rigorous Recordkeeping

By **Shaina Kamen and Max Angel** (May 22, 2024)

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Cryptocurrency has revolutionized the financial markets, but also created tax traps for the unwary investor.

Building on proposed regulations issued last year, the Internal Revenue Service recently increased its oversight of cryptocurrency transactions by requiring brokers to report investor sales and exchanges in connection with such transactions.

A new draft form, published on April 18, specifies the type of information the IRS is seeking from brokers. This new oversight is scheduled for implementation beginning in 2025.

Taxpayers were already subject to IRS reporting requirements in connection with cryptocurrency transactions. If an investor does not comply with these requirements, the IRS may impose accuracy penalties.

To aid in reporting, investors should maintain detailed records of any and all cryptocurrency transactions, including the date of the transaction, the value in U.S. dollars at the time of the transaction and the purpose of the transaction.

Any form of virtual currency is treated for federal tax purposes as property — not cash. For this reason, principles of property taxation apply to transactions relating to virtual currency.

In recent years, the IRS modified reporting requirements so that certain transactions relating to digital assets — and not just virtual currency — trigger reporting requirements with respect to the taxpayer's Form 1040, U.S. income tax return.

Specifically, the instructions for the income tax return and related filings now address, in part, (1) the receipt of digital assets as payment for property or services, and (2) the transfer of digital assets by sale, exchange, gift or other disposition.

Taxpayers should be made aware that receiving or disposing of cryptocurrency may trigger certain reporting requirements with the IRS in the situations discussed below.

Receiving Digital Assets as Payment for Property or Services Provided

Individuals who receive digital assets as part of compensation must report the value of the assets received as wages. The value of digital assets received by the individual, whether as a W-2 employee or an independent contractor, must be reported on the individual's Form 1040. The IRS guidelines suggest that the value of the digital asset at the time of receipt must be used for reporting purposes — even if the value is lower at the time the income tax return is filed.

Certain employees who receive equity in digital assets as compensation may make an 83B election with the IRS in order to pay taxes on the total fair market value of the equity at the time of receipt, rather than waiting for the equity to fully vest in the future. The taxpayer must make the election within 30 days of receiving the equity — or token.

Because taxes are calculated on the fair market value at the time of receipt, the election can potentially reduce the total tax paid by the recipient if the cryptocurrency increases in value over the vesting period.

However, if the value of the cryptocurrency is ultimately less than the value at the time the 83B election was made, the taxpayer may pay a so-called phantom tax, meaning that the taxpayer cannot recoup the taxes paid on the higher valuation.

Selling Digital Assets

Investors must report the sale of digital assets along with any capital gains or losses on their tax returns. This includes exchanging one type of cryptocurrency for another, using cryptocurrency to purchase goods or services, and selling cryptocurrency for fiat currency — government-issued currency such as a U.S. dollar, euro or British pound sterling.

When an investor sells cryptocurrency, the transaction must be detailed on IRS Form 8949 for reporting sales and other dispositions of capital assets. Subsequently, the information from Form 8949 is summarized on Schedule D to the taxpayer's Form 1040, the schedule used to report capital gains and losses with respect to the individual income tax return.

Receiving Digital Assets Through Mining, Staking and Airdrops

Income received from mining, staking or airdrops is taxable and must be reported as ordinary income using the fair market value of the cryptocurrency at the time it was received. Further, income from mining or staking may be reported on Form 1099-MISC if it is conducted as a business.

Digital Assets and Foreign Asset Reporting

U.S. taxpayers with cryptocurrency held in foreign exchanges or wallets that exceed certain thresholds may be subject to further reporting to the U.S. Department of the Treasury's Financial Crimes Enforcement Network — including filing FinCEN Form 114 (foreign bank and financial accounts report) or FinCEN Form 8938 (statement of specified foreign financial assets).

Gift Tax Reporting

If an individual transfers cryptocurrency to another individual by gift, the value of the gift may be subject to gift tax reporting requirements. In the U.S., the IRS allows individual donors to gift assets having up to a certain value each year to donees without using the donor's gift tax exemption.

As of this year, the annual gift tax exclusion amount is $18,000 per recipient. If the value of the cryptocurrency gift exceeds this exclusion amount, the donor is required to report the gift on Form 709, the U.S. gift and generation-skipping transfer tax return.

However, the gift tax is typically not owed unless the total lifetime gifts exceed the lifetime gift tax exemption, which is quite high — more than $13 million per individual as of 2024. Still, reporting the gift is necessary to keep track of the donor's lifetime exemption.

Charitable Contributions

When cryptocurrency is donated to a qualified charitable organization, it may not trigger a capital gains tax, and the donor can often claim an income tax deduction for the fair market value of the cryptocurrency at the time of the donation. This requires detailed records and, typically, appraisals for more significant transfers. This could be a powerful estate planning tool for those with significant cryptocurrency holdings.

Crypto Exchanges and Transactions

Exchanging one cryptocurrency for another is generally considered a taxable event, and taxpayers must report these transactions and calculate any capital gains or losses based on the fair market value of both the cryptocurrency sold and the cryptocurrency acquired at the time of the exchange.

Similarly, using cryptocurrency to pay for goods or services is also a taxable event.

New Cryptocurrency Reporting Form

The IRS recently unveiled a draft of Form 1099-DA, titled "Digital Asset Proceeds from Broker Transactions," signaling a significant development in cryptocurrency tax reporting.

This represents a big step forward in the IRS' efforts to enhance oversight of cryptocurrency transactions by requiring brokers to report investor sales and exchanges of digital assets beginning in 2025.

The proposed regulations would mandate brokers, including digital asset trading platforms and payment processors, to report customers' sales and exchanges of digital assets on Form 1099-DA starting Jan. 1, 2025. Additionally, parties to certain types of real estate transactions would be required to report digital asset dispositions and fair market values in real estate transactions closing on or after the same date.

Recipients of Form 1099-DA are advised to affirm their involvement in digital asset transactions on their tax returns.

Interestingly, the draft form also requires reporting wash sale losses that have been disallowed. The wash sales regulations prevent individuals from selling and purchasing a substantially identical security within a 30-day period, although this rule does not presently extend to cryptocurrency transactions. However, this section of the draft form is significant as it is potentially hinting that the IRS may attempt to ban crypto wash sales altogether.

Conclusion

In summary, the increasing regulatory oversight and reporting requirements surrounding cryptocurrency transactions underscore the importance of diligent recordkeeping and compliance for investors.

As the IRS tightens its grip on the taxation of digital assets, taxpayers must accurately report various transactions, from receiving digital assets as compensation to charitable contributions and exchanges. The introduction of Form 1099-DA signifies a pivotal moment in the IRS' efforts to track cryptocurrency activities.

As cryptocurrency continues to reshape the financial landscape, adherence to tax regulations will help investors mitigate risks and ensure financial security. By maintaining comprehensive records and understanding the tax implications of each transaction, investors can navigate the evolving regulatory landscape with confidence.

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