Considering Cryptocurrency Tax Myths

by Robert W. Wood and Alex Brown

Robert W. Wood

Alex Brown

Robert W. Wood (Wood@WoodLLP.com) and Alex Brown (Brown@WoodLLP.com) are tax lawyers with Wood LLP in San Francisco.

In this article, Wood and Brown dispel myths about cryptocurrency that gullible taxpayers who hope to avoid taxes might be swallowing whole.

As tax lawyers for cryptocurrency investors, founders, and exchanges, and plenty of non-crypto taxpayers, we thought we were reasonably sophisticated about tax planning, disclosures, and more. So it was eye-opening to discover some myths about crypto that could lead gullible taxpayers astray. Cryptocurrency is still comparatively new, dating only from 2009 or so, but many of the tax issues it raises aren't materially different from those in other areas. In decades of seeing trends in tax planning, audits, litigation, and enforcement, many tax advisers have likely seen both good and bad ideas.

In the latter category, there were tax shelters such as the: Bond Linked Issue Premium Structure, or BLIPS; Offshore Portfolio Investment Structure, or OPIS; son of Bond and Option Sales Strategy, or son of BOSS; S Corporation Charitable Contribution Strategy, or SC2d; the intermediary transaction strategy, or Midco; and so many others. Like most tax lawyers, we've encountered tax protesters too. We have learned the hard way that when "sovereign citizens" (or any one of several other varieties of tax protesters) contact us asking us to justify the income tax, there is probably no advantage to responding. We like to be polite, however, so we answer many queries in that effort.

But we are probably never going to convince tax protesters that federal taxes apply to them. We are just going to make them angry and frustrate ourselves in an inevitable dialogue that can be quite hard to cut off. Like most tax lawyers, we have seen plenty of foreign account matters too, starting with the 2008 UBS John Doe summons heard 'round the world, after which more than 50,000 taxpayers disclosed foreign accounts in three IRS offshore voluntary disclosure programs.

We have seen our fair share of complex trust and company structures, but in the end, they rarely precluded the IRS or Justice Department from showing that the taxpayer owned or was a beneficiary of the arrangement — and was going to benefit. We were reminded of this recently in connection with crypto. We are well aware, of course, that as with foreign accounts, there are crypto clients who do not report income and gain.

The Coinbase summons seeking cryptocurrency account data has not been the only thing to shake the trees and cause some taxpayers to amend returns and report gain. There were other summonses issued to Kraken, Circle, and Poloniex. And there were also 10,000 IRS letters sent to crypto taxpayers or those suspected of being in that category. The letters came in different versions, but all were reasonably soft nudges to encourage taxpayers to be compliant.

New Age

The IRS hunt for crypto has often been compared to the IRS hunt for foreign accounts over a decade ago. If that comparison is an apt one, then there should be an amnesty or voluntary disclosure program to help bring the affected taxpayers with cryptocurrency into compliance. Unfortunately, it is still not clear if there will ever be a crypto amnesty program, much less several branches of permitted disclosure routes to emulate the multiple flavors of offshore disclosures that the IRS formulated for undisclosed offshore accounts.

We should remember that the IRS made its first big announcement about cryptocurrency comparatively recently, in 2014. In contrast, the IRS had generations to pursue offshore accounts until the agency finally had a watershed success with the 2008 John Doe summons to UBS in Switzerland. Now, 13 years after 2008, the IRS has multiple offshore account disclosure programs that are still running. The fire hose of disclosures from 2008 through 2019 may have slowed to a trickle, but disclosures are still being made. That $50 billion the IRS collected from offshore account matters just keeps growing.

Some observers think that crypto may follow a similar path. That would mean some prosecutions, convictions, and jail time and some massive taxes, penalties, and interest. How fast this will occur is not clear, and COVID-19 has surely slowed down whatever momentum was building. But we are already seeing crypto audits, and more are sure to follow.

One tax issue with a limited life span concerns section 1031 exchanges of crypto. It applies only to 2017 and prior tax years because of amendments to the code effective in 2018, so it seemed a good bet to think that the IRS might not press the issue. But the IRS is already raising section 1031 in audits, and the IRS Office of Chief Counsel has delivered a psalm to the IRS choir with ILM 202124008.

In that legal memorandum, the IRS says that several specific swaps of pre-2018 cryptocurrency do not qualify for section 1031 treatment. We believed that most taxpayers had a grumbling acceptance of the IRS rule that crypto is property, and even of Congress's rule that section 1031 now applies only to real estate, and would get into line and do the best they could with reporting.

Concerning the mechanics of reporting — there are tracking and return preparation alternatives that can make that process much easier than it was in the early days. To be sure, everyone tries to minimize taxable crypto gains and to defer taxes when legally possible. But we somehow had been unaware that there appear to be what one might call crypto tax deniers, some of whom might even rival sovereign citizens in their verve.

We recently made the mistake of trying to engage a crypto tax denier and were unsuccessful in making a dent. As others have noted, perhaps part of the perfect storm is the roots of the crypto movement in the first place. After all, privacy, libertarianism, and lack of government involvement are some of the watchwords that made crypto so attractive — and that are still deep in the DNA of some crypto tax deniers.

For a recent reminder that this theme is alive and well and has many adherents, just look at the controversy over the Senate-approved version of the infrastructure bill, the Infrastructure Investment and Jobs Act, H.R. 3684 (2021). There was a groundswell of outrage about the reporting provisions. As one commentator put it, the provisions "would dramatically expand the government's surveillance of Americans' economic activity and diminish America's role in developing an important new technology."[1] Others have been more strident.

If it is passed in its current form, the proposed law would require cryptocurrency exchanges — defined as "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person" — to file an information return reporting the transaction. The proposed legislation would be effective in 2023.

As it stands now, section 6045 generally imposes Form 1099-B, "Proceeds From Broker and Barter Exchange Transactions," reporting requirements on brokers. A broker includes a "dealer, a barter exchange, and any other person

---

[1] *See* Abraham Sutherland, "The Proposal to Regulate Digital Asset Transactions Should Be Struck," *Tax Notes Federal*, Aug. 16, 2021, p. 1125.

who (for a consideration) regularly acts as a middleman with respect to property or services." The bill expands this definition to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." Brokers will be required to report the adjusted basis and the character of gain or loss upon the sale of digital assets, including utility tokens, stablecoins, and asset-backed tokens.

The law would also expand section 6045A by imposing an additional reporting requirement when a broker transfers a covered security that is a digital asset to "an account which is not maintained by, or an address not associated with, a person that such broker knows or has reason to know is also a broker" (that is, a non-broker). The transferor must file an information return with the IRS containing the same information that would be required in a transfer statement for a broker-to-broker transaction. There are penalties for failure to comply.

New Frontier

Some of what we have found being espoused is probably being consumed by at least some taxpayers who could end up being harmed. In the past, there have been many tax protesters who landed in serious civil tax trouble. Some were even convicted of tax crimes because they bought a book or went to a seminar and got hooked hard. This could happen with crypto too.

Just think about some of the concepts that are being marketed to cryptocurrency investors — who are already probably not happy about how the IRS is going after crypto. Providing limited commentary and omitting source citations, we pass along to the tax community these concepts, which we imagine some tax practitioners may find as surprising as we do.

Myth: Taxes are not owed on cryptocurrency transactions unless you receive a Form 1099. If you did not receive a Form 1099, you can check the box on your tax return that says that you did not have transactions with cryptocurrency.

Response: A Form 1099 does not create a tax obligation when no tax was previously due. Tax may still be owed, even if the payer or broker does not file a Form 1099. A Form 1099 or other reports may report something that turns out not to be income. Filers of Forms 1099 sometimes make mistakes and report things they didn't have to report. But that is not the same as saying that the report creates a tax consequence you did not have.

If you are audited on your cryptocurrency transactions and your best defense is that you chose not to report your transactions because you did not receive a Form 1099, that is not likely a winning position.

Myth: If you hold your crypto through a private wallet instead of an exchange, you don't have to report the cryptocurrency on your tax returns.

Response: Private wallet or exchange, the tax rules are the same. The impulse to hide ownership by moving wealth to increasingly anonymous holding structures is not new. When Swiss banks began disclosing their U.S. account holders to the IRS and the Justice Department, many U.S. taxpayers converted their Swiss accounts to gold held in foreign safety deposit boxes, believing that would avoid withholding because gold does not produce income until sold. When the IRS clarified that gold held in a foreign safety deposit box is reportable on foreign bank account reports as a foreign account, some of those taxpayers removed the gold from their safety deposit boxes and stored it at home or sold it and bought artwork that could be stored at home.

The impulse to stay one step ahead of the reporting regime is often futile. It is always easier for the IRS to expand reporting requirements and to add a new question to the tax form than it is for taxpayers to develop a new way of holding and investing wealth without having to report it. And, when reporting eventually does catch up with how you hold the asset, it does not look good for your willfulness (and the resulting tax penalties) if you have repeatedly moved your assets to stay ahead of the U.S. reporting requirements.

The cryptocurrency question on Form 1040 is not limited to cryptocurrency held through exchanges. If you select "no," even though you hold cryptocurrency through a private wallet, then you are potentially making false statements on a tax return signed under penalties of perjury. At that point, you are essentially betting that you will never get caught, and thousands of U.S. taxpayers that had Swiss bank accounts can attest to how poorly that bet can play out.

Myth: If you hold your cryptocurrency through a trust, limited liability company, or other entity, then you do not owe tax on the cryptocurrency transactions and do not have any reporting obligations for the cryptocurrency. In particular, there are no provisions of the IRC that address the tax treatment of LLCs, so income generated through LLCs is tax free.

Response: Owning cryptocurrency through an entity may keep the income off your personal tax return. But unless the entity qualifies (and is registered) as tax exempt, the entity itself would likely have tax reporting obligations and may owe tax on the cryptocurrency transactions.

In some cases involving disregarded entities, partnerships, some LLCs, some trusts, and some foreign entities under the subpart F rules (among other situations, we're sure), you may still owe tax on your personal tax return for income generated within the entity. Therefore, it is categorically untrue that owning your crypto through an entity per se means you do not owe tax on the crypto.

While there isn't a separate section of the IRC that deals with the tax treatment of LLCs, there are significant sections that deal with the tax treatment of corporations and partnerships. For tax purposes, LLCs are taxed as corporations or partnerships depending on their specific facts and tax elections. Or, in the case of single-member LLCs, they are disregarded, so the LLC income ends up on the sole owner's return. So there is no real controversy within the tax law that LLCs (or their members) are subject to tax on the income they produce.

But you might say, "My entity is a foreign entity and therefore not subject to U.S. tax." Perhaps, but subpart F and other provisions of the code are quite effective at looking through foreign entities that are used to hold U.S. taxpayers' passive investment assets (like crypto) and making U.S. taxpayers directly liable for some income produced within the foreign entity.

Myth: If I structure the sale of my cryptocurrency as a loan (or some other non-sale transaction), I don't have to report the proceeds.

Response: But are you actually lending or selling the crypto? The IRS and courts have a robust set of doctrines to look through or disregard sham transactions. Are you getting the same crypto back that you are purportedly lending? Are you charging interest on the loan and recognizing that interest as income as you receive it? If not, calling a sale a loan likely won't hold water.

And if you're selling crypto and receiving a promissory note, the involvement of a promissory note doesn't avoid sale treatment. If anything, that may just complicate your reporting further by involving installment sale calculations.

Myth: A crypto exchange is a type of trust because you cannot unilaterally change the policies of the exchange. Accordingly, you do not own the cryptocurrency in your account for tax purposes and do not have to report transactions that occur through an exchange.

Response: The IRS has not released guidance suggesting it views cryptocurrency exchanges as trusts or that taxpayers do not have to report assets held through cryptocurrency exchanges. Indeed, IRS guidance strongly suggests that it views taxpayers as owning the cryptocurrency held through their exchange accounts.

Except in extraordinary circumstances, it seems highly unlikely that the IRS would view cryptocurrency held through an exchange account as owned by the exchange itself (as trustee) rather than by the account holder. Taxpayers often own assets through accounts held by institutions: bank accounts, investment accounts, 401(k)s, and IRAs, to name a few.

Most taxpayers' liquid assets are held through some sort of custodial account. Taxpayers do not have the unilateral right to change the policies of the banks and investment companies that manage their accounts. Still, in most cases, the tax law recognizes that taxpayers "own" the money and other assets held through these accounts (although some, like 401(k)s and IRAs, are subject to preferential tax rules). There is no reason to believe that cryptocurrency exchange accounts would be fundamentally different.

Moreover, as anyone who has a foreign pension account (like an Australian superannuation fund) can attest, having an account treated as a trust is not necessarily a good result for the taxpayer. Beneficiaries of trusts, and particularly foreign trusts, have truly onerous reporting obligations. Thus, if the tax argument being proposed is to consider crypto exchanges as trusts, be careful what you wish for.

Trusts and their beneficiaries are regularly subject to tax and reporting obligations under the IRC. Therefore, calling something a trust does not mean income generated within the trust is exempt from income tax.

Myth: Congress's amendment to section 1031 that limits like-kind exchange treatment to real property does not make crypto-to-crypto exchanges taxable.

Response: Section 1001 provides that taxable gain results from the "sale or other disposition of property." Therefore, the sale of any type of property for cash or other property presumptively can create taxable gain. According to the IRS, crypto is property, so surrendering crypto for other crypto is the sale of crypto for the value of the new crypto received.

To avoid gain, a taxpayer must be able to point to a tax authority that provides that a particular gain is exempt from the general rule of section 1001. Before the amendment of section 1031, taxpayers may have reasonably taken the position that the crypto-for-crypto sale was excepted from section 1001 because it qualified as a like-kind exchange under section 1031. But now that section 1031 has limited like-kind exchange treatment to real property, taxpayers with crypto-for-crypto sales appear to be left with the default rule of taxable gain under section 1001 unless they qualify for another exception.

Conclusion

We do not mean to single out any particular commentator or adviser to crypto investors or companies. But we do think taxpayers should be wary of quick fixes and theories that sound too good to be true. We have seen several taxpayers with big crypto tax messes to clean up, but they generally get in line and do their best to do that. Even so, the IRS appears to believe that many crypto taxpayers are not complying with the tax law.

The groundswell of pushback the blockchain community has mounted to the broker reporting requirements in the infrastructure bill may merely suggest that the crypto community wants to avoid what some say could be crippling regulation. In any event, the IRS has made no secret of the fact that it is going after crypto in a big way. Most people get in line and try to do their best with compliance, even if they disagree with the IRS about many points. But if gullible investors buy into tax theories that seem to be percolating, some people may end up stung. ■