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Tax Notes

The Taxation of Digital Assets in the U.S.
Is the Infrastructure Bill a "Shot Across the Bow"?

By Thomas Riggs, JD, CPA, MAS, Partner

Early in 2009, under the pseudonym "Satoshi Nakamoto," the genesis block (block zero) containing 50 algorithmic entries was registered on his (or her?) newly-created digital ledger. Those original 50 algorithmic entries eventually became known as "Bitcoins," and that digital ledger: the "Blockchain." The ensuing 12-year period of unprecedented growth of the digital ecosystem in the U.S. has been aided in large measure by what some would call lax regulation and tax enforcement. However, two crypto-related tax provisions were inserted into the recently-enacted infrastructure bill, which may signal that the benign crypto landscape in the U.S. may be coming to an inauspicious end.

The Backstory

Yes, as incredible as it may seem, the entire digital asset space is a mere 12 years old. During this brief period, the aggregate market value of all digital currencies has grown in size to exceed that of the entire high yield bond market in the U.S., and, as of this writing, that growth trajectory appears to be continuing unabated. Governments across the globe have been playing catch-up during this period of unprecedented growth … struggling to stay ahead of digital developments occurring at break-neck speed. And, they continue to struggle today with how to properly regulate, tax and implement appropriate investment and economic guardrails across the space.

With respect to the pace of digital adoption, different nations across the globe have travelled the digital highway at different speeds.

On one end of the spectrum are nations that have embraced the new digital frontier with open arms. Several Asian nations, including Vietnam and Pakistan are far ahead of most in their overall adoption of digitalized commerce. In Europe, certain EU countries, including Switzerland and Germany have almost entirely shielded crypto-related profits from taxation. And, the country of El Salvador has recently gone so far as to become the first nation to officially adopt Bitcoin as legal tender.

In contrast, certain other nations have viewed the explosion in cryptocurrency and digital assets with trepidation, fearing that if left alone the digital revolution could potentially overwhelm governmental control of currency, the economy, and ultimately the ability to govern. This has led these countries to impose severe restrictions on digital assets, or even attempt to purge them from their economies altogether. For example, Russia has banned all transactional use of cryptocurrency, but does allow their citizenry to own it for passive investment purposes. China has gone even further … recently banning all private cryptocurrency activity in its entirety (although the Chinese government continues to be in late stage development of a digital Yuan). The Chinese case is particularly poignant in that prior to the outright ban, an estimated 75% of all Bitcoin mining was carried out in China.

Here in the U.S., the twin regulatory and tax frameworks surrounding digital assets have been somewhat slow to develop. This is due in no small measure to the dissonance of two opposing viewpoints in Congress. In one camp are those who caution against over regulation and/or taxation of the nascent industry, fearing a chilling effect on innovation and/or driving the best and brightest in the industry to more hospitable offshore jurisdictions. In the House, high profile supporters of this view include Trey Hollingsworth (R-IN), as well as Congressional Blockchain Caucus members Tom Emmer (R-MN) and Darren Soto (D-FL). In the Senate, vocal advocates for the digital space include Ted Cruz (R-TX), Ron Wyden (D-OR), and Pat Toomey (R-PA).

The opposing camp, however, views the digital revolution through a more wary eye. The fear is a situation in which a lack of transparency and/or oversight results in the inability of our government to "stay ahead of the curve," rendering it difficult to maintain appropriate regulatory safeguards as well as to secure tax compliance. Influential Senators holding this view include Rob Portman (R-OH) and Mark Warner (D-VA). And we note that it was Senator Portman who, at the 11th hour, succeeded in inserting the subject digital-related provisions into the infrastructure bill just prior to its passage in the Senate.

Passage of the Infrastructure Bill

On November 15th, 2021, President Biden signed into law HR 3684, The "Infrastructure Investment and Jobs Act" (the "Bill"). The Bill appropriates $1.2 trillion of welcome funding for a multitude of "hard" infrastructure projects, including upgrading roads, bridges, airports, water systems, and broadband architecture, as well as containing certain other non-infrastructure related provisions, including ending the Employee Retention Credit. After first passing the Senate with bipartisan support back on August 10th, the Bill was held up for over three months by a relatively small faction in the House, pending assurances from House Speaker Nancy Pelosi (D-CA) that its twin social spending package, the $2 trillion Build Back Better bill (BBB), would be brought up for a vote in the House before the end of November.

After a period of extensive back door and supposedly heated negotiations, the Bill finally passed the House … with 13 Republicans voting in favor and six Democrats voting against. Speaker Pelosi had made good on her pledge … which, in turn, broke the logjam in the House and allowed her to, in turn, secure House passage of BBB on November 19, 2021, just four days later. BBB now moves over to the Senate, where a small faction of Senate moderates, led most notably by Senators Joe Manchin (D-WV) and Kyrsten Sinema (D-AZ), have raised concerns about the size and scope of the spending package. As such, significant revisions to the BBB bill are anticipated in the Senate.

Getting the Bill across the legislative finish line represented a hard fought victory for the Democratic Congress, the Biden Administration and for Speaker Pelosi personally. It also demonstrated that true bipartisan governance is possible, while at the same time potentially aiding the Democratic Party in garnering much needed support ahead of the November 2022 midterms. But what, you might ask, does all of this have to do with the taxation of digital assets? Turns out a great deal.

The Bill's Digital Asset Provisions

Tucked into three of the 2,700+ pages of the Bill are two controversial provisions which represent the first attempt by Congress to exert direct legislative control over the digital space. Taken together, they seek to dramatically increase transparency in order to afford both U.S. regulators and the Internal Revenue Service (IRS) a clearer view into the digital activities of participants in the digital ecosystem … both onshore and offshore. And, if Senator Portman is to be taken at his word, this initial legislative foray is but a prelude to more in the offing.

The two subject provisions can be summarized as follows:

1. **New Reporting Requirements for the Receipt of Digital Assets Valued at $10,000 or More**

   Currently, 26 U.S.C. § 6050I of the Internal Revenue Code requires that any business that receives $10,000 in cash or non-traceable cash equivalent (e.g., a money order) from any party must report the receipt to the IRS. The report is made on Form 8300, and it must contain the identifying information and address of the remitter, including their tax ID number. Penalties for failure to report are draconian, with civil fines capped at $3 million, and willful violations constituting a felony punishable by up to 5 years imprisonment. We note that the provision's $10,000 threshold became law in 1984, and that the inflation-adjusted value of that threshold in today's dollars would approach $30,000. A legislative revision of the threshold upward has been discussed, but has never made its way into law.

- *The Bill expands the definition of "cash" in the above-referenced statute to include digital assets, thus expanding the statutory reporting requirement to the receipt of any digital asset of $10,000 or more in value.* The term "digital asset" is defined quite 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." As written, the definition is potentially sweeping in scope and could ensnare everyday transactions across the digital universe, for example paying for an NFT with Ethereum, or even trading or swapping cryptocurrencies.

The provision is effective for receipts after December 31, 2023, an implicit acknowledgment that much remains to be done by way of interpretational guidelines and implementation mechanics.

2. New Reporting Requirements for Digital "Brokers"

Currently, 26 U.S.C. § 6045 of the Internal Revenue Code requires that "brokers" provide to their customers and to the IRS an annual summary of customer transactions in "specified securities." This requirement is commonly referred to as the Form 1099 reporting regime. The annual summary must include the name and identifying information of the customer, along with other information such as the aggregate tax basis and gain/loss information for customer transactions during the calendar year. Brokers are also required to report transfers of "specified securities" to non-brokers.

- The Bill expands the term "specified securities" to include digital assets (as defined in 1. above). Additionally, it defines a "broker" as any person who provides "*any service effectuating transfers of digital assets on behalf of another person*." As in the case of the $10,000 cash reporting requirement discussed above, the definition of a "broker" is extremely broad, and could be interpreted to include not only digital asset exchanges and crypto-based payment platforms, but potentially a host of other participants across the crypto ecosystem, including miners and wallet custodians.

This second provision expanding the definition of a "broker" apparently struck a nerve, as it took less than a week for competing bills to be introduced in the Senate by the two camps discussed earlier in this article, one limiting the definition and the other refining and supporting it. Consequently, we expect clarifying legislation to be forthcoming.

The provision overall is slated to take effect for transfers made after December 31, 2022, again an implicit acknowledgment that interpretational guidelines, implementation mechanics, and perhaps supplemental legislation remain on the horizon.

Conclusion

The explosive growth experienced across the digital ecosystem over the last 12 years has occurred with the regulatory and tax winds at its back. Newly-enacted disclosure and reporting provisions appear to reflect a new activism on the part of the U.S Congress with respect to this burgeoning industry. Stay tuned.

Contact Us

If you have any questions or need assistance, please contact:

Thomas Riggs, JD, CPA, MAS
Partner
triggs@pkfod.com | 646.449.6317

About PKF O'Connor Davies