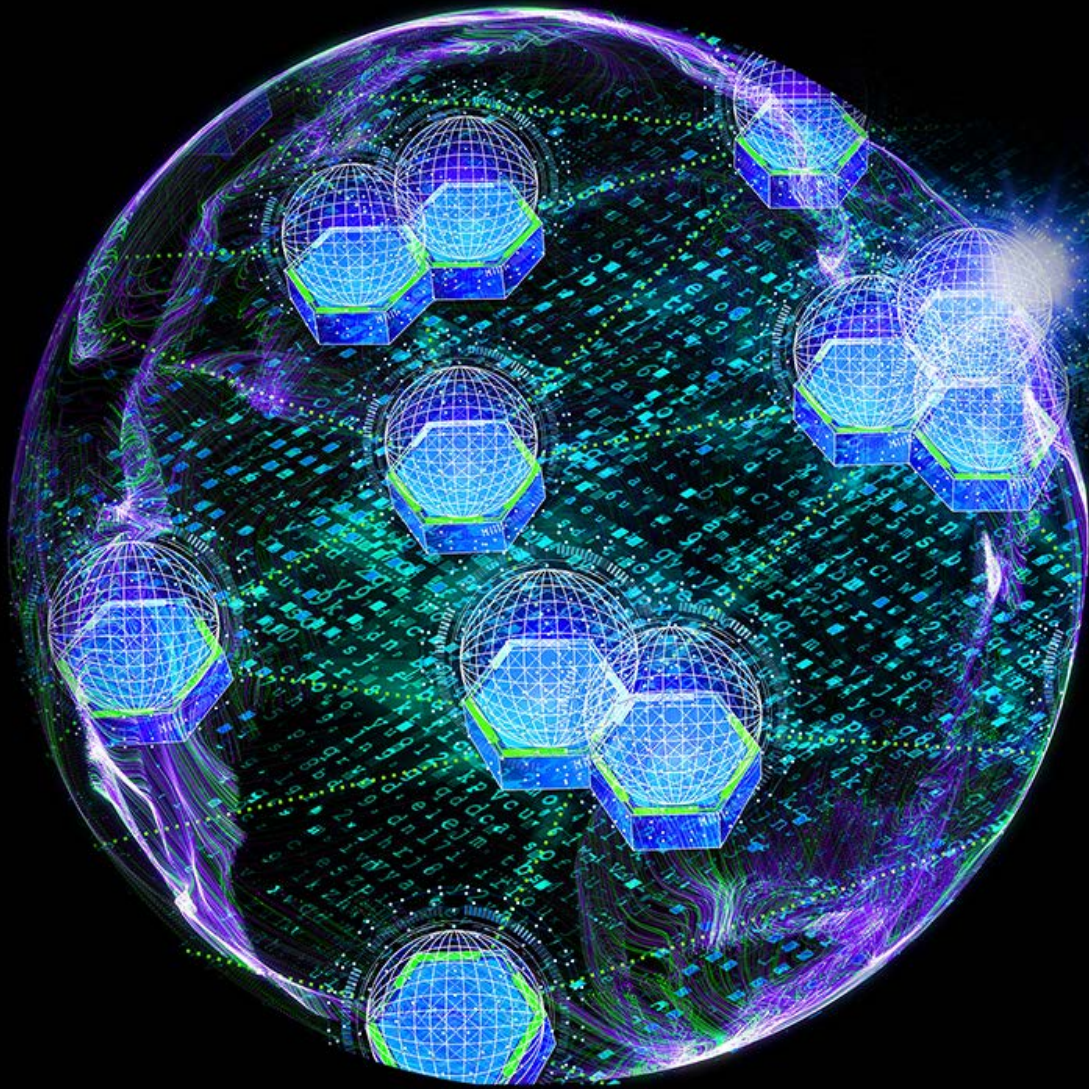


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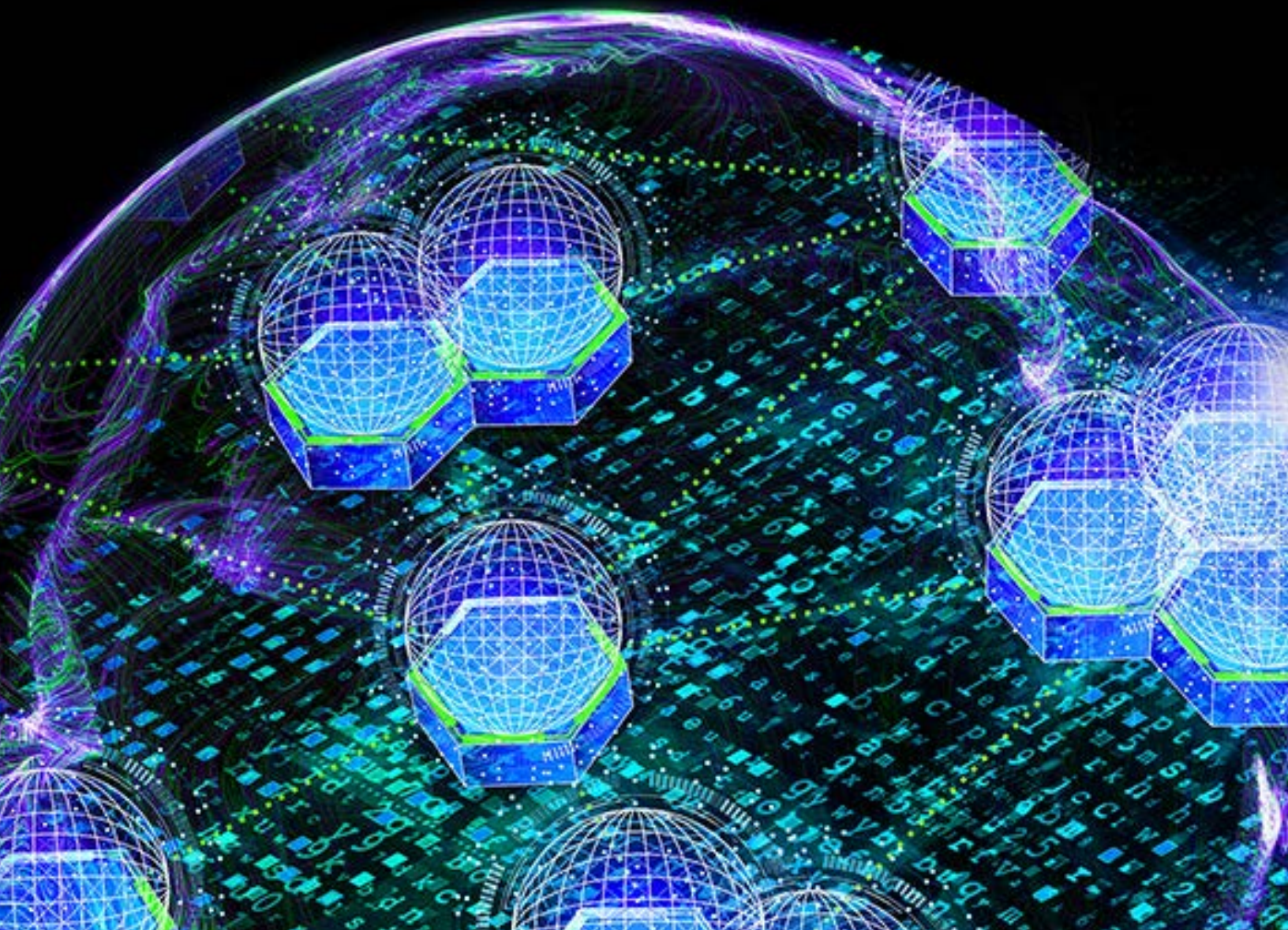


Tax controversy in crypto

Getting ready for the IRS exam

Introduction

With a surge in IRS crypto audits expected in 2024, it's not just tax evaders at risk—it's unsuspecting taxpayers too. The crucial question: Have you addressed your digital asset tax implications and crypto tax reporting requirements? Both individuals and corporations must take proactive steps to navigate potential audits and reduce financial risk.



The lay of the land

IRS interest in crypto transactions

On September 8, 2023, the IRS announced that it would devote substantial additional attention to digital asset transactions. The reason? A 75% non-compliance rate among taxpayers it had identified through records retrieved from digital currency exchanges.¹ Moreover, the IRS expects that, beginning in fiscal year 2024, there will be significantly more digital asset audits and examinations of digital asset holders.

Some two weeks before the IRS announcement, on August 25, 2023, the US Department of the Treasury released proposed regulations regarding the sale and exchange of digital assets by brokers. Their intent? "To crack down on tax cheats while helping law-abiding taxpayers know how much they owe on the sale or exchange of digital assets."²

According to the Treasury, "[The proposed regulations are] part of a broader effort at Treasury to close the tax gap, address the tax evasion risks posed by digital assets, and help ensure that everyone plays by the same set of rules."³

This additional announcement may well seek to prepare the public for a potential wave of IRS activity around digital asset examinations. Nevertheless, these statements also seem to discount the multitude of transactions performed not by tax cheats and criminals, but by regular taxpayers operating with less than complete guidance provided by the current regulatory framework.⁴

And that brings us to the core question motivating this brief review of the tax landscape for digital assets: Have you or your company thought about how you've been reporting your digital asset holdings and transactions for tax purposes? If you haven't received a Form 1099, the matter may have escaped your attention. But digital asset holders should be prepared for a potential IRS audit.

For those who transact in digital assets—individuals and corporate entities alike—you may want to consider preparing for an IRS examination. And that may well mean a deep dive into your digital wallets and, consequently, digital asset transactions. By taking a good hard and earnest look at your exposure today, you may save time and expenses in the form of representation fees and potentially stave off accuracy-related penalties.

Proposed regulations

On August 25, 2023, the US Department of the Treasury and the IRS released proposed regulations covering digital asset reporting. The proposed regulations represent a first draft, but the intent seems clear. The IRS and Treasury may well want to see all your on-chain activity and may expect that any facilitator of a digital asset transaction will report such activity. As currently drafted, effective January 1, 2025, the proposed regulations would require a broker to report the proceeds of digital asset transactions. More germane, however, is the proposed reg. § 1.6045-1(d)(2)(i)(B) that would require the broker to report:

- The transaction identification (transaction ID or transaction hash) associated with the digital asset sale, if any.
- The digital asset address (or digital asset addresses if multiple) from which the digital asset was transferred in connection with the sale, if any.

It's worth underscoring that such information would likely not only provide the IRS not only with information about the specific transaction at issue but enable agents to observe current and past on-chain activity and possibly determine whether there are previously unreported transactions. That kind of visibility might well lead to significant exposure for taxpayers who are less than fully conversant with the complexities of the current and incomplete regulatory landscape.

Statute considerations

Typically, the IRS's ability to make a tax assessment is limited to three years.⁵ However, in instances where the IRS can prove that the taxpayer failed to report income that constitutes part of the taxpayer's gross income, the rules change. If the omitted income exceeded 25% of the gross income reported for the tax year, the IRS can then make an assessment for up to six years.⁶ Furthermore, if the IRS can prove the taxpayer engaged in fraud by under-reporting, then there is no time limit to the assessment. While fraudulent intent can be difficult to prove, take a moment to recall how you answered the check box question on your Form 1040 about any digital asset transactions. A simple misstatement could be interpreted as a justification for further investigation and possible assessment on an otherwise time-barred year.

Current state of IRS examinations involving digital assets

The silent investigation

It's worth remembering that the IRS starts to gather information about your activities well before you receive your first written notification.

Individuals and companies alike are perhaps inadvertently becoming more transparent about their use of digital assets through social media and other channels. Unbeknown to most, however, one of their followers may well be an IRS examining agent.

It is common knowledge that people are sharing more information about themselves with broader audiences. But less frequently discussed is the amount and types of information businesses share. There's a growing expectation that businesses will continue to share more about their use of customer information, internal operations, proprietary computer codes, and more. In such an environment, yesterday's discreet press release becomes tomorrow's widely viewed post or tweet. And the days of closely guarded code with its voluminous documentation to support each intensioned segment has given way to public cloud-based code repositories—such as Gitlab and Github. And these repositories can also provide pertinent commentary from the developers. CodeCommit is a version control service hosted by Amazon Web Services that enables users to privately store and manage assets such as documents, source code, and binary files in the cloud. So, those taxpayers engaged in such communities need to take into account how the IRS could interpret their social media posts, website disclosures, or any commentary about their developer community.

In areas of tax law that deal with your intent or business purpose, or areas that are simply legally ambiguous (as is sometimes the case with crypto), how the IRS interprets the facts is just as important as the facts themselves. It is difficult enough to manage the situation when the only facts on the table are those adduced during the examination itself. However, when you layer on a cornucopia of pithy statements and posts made for public consumption, it becomes all the more difficult to sustain a consistent narrative. That's why a thoughtful analysis of all publicly available information that you may have generated or released is imperative in anticipation of an opening conference with the IRS. It can also help with an affirmative presentation that can limit the significance of inconsistencies and promote a strong and clear tax narrative.

Scrupulous examinations

Initial Information Document Requests (IDRs) made by the IRS may include questions related to digital asset transactions. The following are the types of information being gathered.

01. Issuance of John Doe Summons: A request from the IRS for information about an unidentified taxpayer that identifies broad categories of information from exchange platforms. That information can include:

- User profile, user preferences, or account application information, regardless of how it is labeled or maintained, as follows:
 - Name (including full name, any pseudonym, or any user ID);
 - Date of birth;
 - Taxpayer identification number;
 - Physical address;
 - Telephone number;
 - Email address; and
 - Wallet address where digital assets have been transferred to or from.
- All records of activity in the user's account including, but not limited to:
 - Records identifying the date, time, amount, and US dollar value of any purchase or sale of cryptocurrency in exchange for US dollars or foreign legal tender (fiat currencies) or other cryptocurrency.

- Records identifying the date, time, value (or expense) of any lending, borrowing, or margin position entered into in the account.
- Records identifying the date, time, amount, US dollar value, transaction hash (ID), and blockchain addresses for cryptocurrency unit transferred into or out of the user's account from another user whether inside or outside of the exchange in question.
- Records identifying the date, time, amount, and US dollar value of any units of cryptocurrency received by the user in the account as a result of a chain-splitting event, such as a hard fork or a promotional event like an airdrop.
- All records of account funding (deposits, withdrawals, or transfers) in US dollars or foreign legal tender. That includes transactions conducted through automated clearing House (ACH) transfers, wire, or other electronic transfers, or any other form, as well as any and all invoices, billing statements, receipts, or other documents memorializing and describing such transactions. Naturally that information is available to the extent records are contained within the exchange's existing transactional ledgers.



02. Once officially under IRS exam, the information that agents are likely to request from the individual taxpayer is far more exact and detailed than that typically gathered in a John Doe Summons. Some of the requests and questions below apply to individuals, while others apply to corporates dealing in crypto:

- Standard requests
 - All books and records
 - All pertinent notes, resolutions, and board minutes
- More specific requests with regard to employees paid in digital assets:
 - Service contracts and agreements, including contract modifications and assignments with the individuals or corporation being examined
 - Records of work performed, including assignments, positions/ title, responsibilities, contract modifications, proposals, and dates services were rendered
 - Details of transaction flows, time stamps, and the supporting documentation used to reference the value at the time of transfer

Agents are also likely to request records of all communications between the taxpayers and the service providers. They may further request the following, depending on the circumstances of the case:

- In instances involving the disposition of digital assets without a readily ascertainable value, they may request documents and information relating to how the value would be determined, the decision to enter into the private sale, the negotiation of the private sale, how the private sale was to be effected, and the delivery of the asset. This request includes, but is not limited to, sale agreements, as well as communications between the buyer and seller.
- Records of any corporate distributions of digital assets.
- All documents and information, relating to transfers of any assets between digital wallets.
- Any documentation that might enable the IRS to trace the flow of funds between or among digital wallets.
- For all transactions, the digital wallet address that received assets, and the identity of the owner of the given wallet address.
- All documents and information related to the taxpayer's receipt of virtual currencies in this digital wallet on behalf of another party if they are the owner of a given digital wallet and they received virtual currencies in this wallet on another party's behalf.
- Information to show how digital asset transactions reconcile to books and records.

To determine how books and records may or may not reconcile with the tax return, agents are likely to ask for:

- All marketing, advertising, solicitation, promotional, and informational materials and updates, as well as educational communications from the taxpayer (or on the taxpayer's behalf) to customers, potential customers, DApp developers, investors, potential investors, and third parties whether on paper or electronic media, including but not limited to Reddit, Facebook, Facebook Messenger, WhatsApp, Skype, Medium, Telegram, WeChat, QQ, emails, KakaoTalk, Weibo, Twitter, GitHub, Rocket Chat, YouTube, Slack, and Meetup.
- All documents, memoranda, reports, legal opinions, and correspondence relating to the book and the tax treatment of transactions.

03. In the course of a detailed exam, agents are likely to undertake a detailed review of tax positions. That review can entail a deep dive into:

- Methods of accounting: specific identification of digital assets, tracking, including use of first-in first-out (FIFO), etc.
- Character of digital asset transactions (e.g., capital vs. ordinary).
- Holding period used for dispositions.
- Treatment of staking rewards.
- Service arrangements and the application of section 83(b) elections (i.e., employees and other service providers electing to include as taxable income the value of an unvested award at the time of transfer).
- informational reporting of digital assets transferred to contractors or vendors.
- Sourcing of revenue or gain transactions

04. As a backdrop to these requests, taxpayers and corporations alike should bear these facts in mind about the statute of limitations, also noted above:

- The default statute of limitations for the assessment of additional tax is three years. However, where the IRS determines that a taxpayer has underreported gross income by 25%, a substantial omission under IRC section 6501(e), the statute is extended to six years.
- These rules can constitute a significant risk despite what taxpayers may believe about the relevance or auditability of past omissions.

05. What provisional conclusions can we draw from this detailed list of information requests and areas of interest to the IRS? The IRS's understanding of how to trace cryptocurrency transactions has evolved to encompass new realities. For example:

- The IRS is aware that taxpayers may have been party to taxable dispositions of digital assets outside the realm of centralized cryptocurrency exchanges (e.g., sales and dispositions through DeFi platforms).
- Open-source software development may be able to provide regulators with a transparent trail of who participated in its development, and the original site of those activities.
- By connecting a taxpayer's true identity to their pseudonymous on-chain identity, authorities may be able to uncover misreported or unreported taxable transactions and/or indications of certain off-chain activities (such as sales and marketing) occurring in a specific jurisdiction.
- The transparent nature of blockchains may provide regulators insight into the active operational jurisdictions of a taxpayer (e.g., staking tokens to a US-based node operator).

How can a trusted advisor assist you?

There are a number of steps—both preemptive and remedial—with which an adviser, such as Deloitte Tax LLP, can assist you. A brief, albeit incomplete, list could include:

- Compliance engagements. Advisers can help:
 - Provide accuracy in reporting in tax returns. Reconcile input and output transactions associated with digital wallets to the books and records that a taxpayer uses to support a tax return.
 - Complete Form 8275 to document to the IRS the reasonable basis for your position, and in a way that reduces the risk for accuracy-related penalties.
- Preparation for your first IDR before receipt of any formal request. Advisers can help:
 - Leverage their knowledge of your business and your online identity to help you assess your exposure to any risk
 - Conduct mock crypto audits by assembling a team of Deloitte professionals that can deliver to you or your company a depth of knowledge in terms of digital asset transactions and the ways in which the IRS might assess an individual's or entity's possible overall tax exposure; and furnish pertinent guidance on how to prepare for a potential IRS examination. Mock audit sessions typically include:
 - > Examination of public statements on social media including cloud-based repositories activity that may exist in public repositories to determine how your tax narrative might be affected
 - > Assistance with maintaining clean books and records as they relate to digital asset transactions with an emphasis on:
 - Basis tracking methodology and application.
 - Character determination of property (i.e., capital vs. ordinary).
 - Where necessary, document justifications for positions taken contemporaneously regarding:
 - > Staking.
 - > DeFi activity.
 - > Token warrants.
 - > Market making agreements.
 - > Token loans.
- IRS exam/appeals representation is likely to be of value to individual taxpayers and corporations alike given both the complexity and incompleteness of the regulatory framework governing digital assets. Advisers can:
 - Help pull together documentation and supporting evidence for the tax positions that you or your company may have taken on your return.
 - Assist with flagging the facts to consider as you frame your broader tax narrative and address any apparent inconsistencies.
 - Share with IRS agents some of the leading business and operations practices that are currently being implemented in different industries with regard to the use, accounting, tracking, and tax preparation for digital assets.
 - Analyze and work with relevant regulatory interpretations for purposes of a return position that can be articulated clearly to the IRS.
 - Create efficiencies as the result of IRS audits when/if they occur.
 - When appropriate, help to develop remediation road maps for prior years' filings.

Where are we headed?

It is quite clear that tax authorities—both federal and state—are interested in uncovering any discrepancies or shortcomings between the tax rules to which typical law-abiding citizens adhere and those to which the holders of digital assets (law-abiding or otherwise) are asked to adhere. In that broader context, the new proposed regulations regarding digital assets are only a single point of reference in a broader universe of complexity.

That said, in the last few years, it is clear that the IRS has had unprecedented recourse to the use of the John Doe Summons (i.e., a summons that does not identify the person with respect to whose liability the summons was actually issued).

To support the issuance of this sweeping summons, the government has cited various studies that indicate the potential for abuse in digital asset transactions and related tax matters.

Although the number of taxpayers reporting cryptocurrency transactions has increased in recent years, the crypto tax reporting rates still fall far short of what would be expected given the information about number of users, transactions, and value that the virtual currency exchanges publish on an annual basis.

Anecdotally, too, Deloitte has noted increased IRS interest in digital asset holdings in the course of broader-focused IRS examinations of a host of clients in various industries. And it's not uncommon for the first set of Information Document Requests to focus on any transactions involving digital assets. To the extent that such transactions took place, the IRS has not hesitated to examine meticulously the tax treatment of those transactions. Those efforts cover a wide range of matters including delving into issues related to basis tracking, the specific identification of the assets being traded, etc. Despite the noticeably heightened governmental focus on digital assets, there is agreement among many users that the lack of comprehensive guidance on the tax treatment of digital asset transactions is a matter of both concern and confusion.

Where do all these different strands of inquiry and complexity leave us? For those who transact in digital assets—individuals and entities alike—they should be prepared for a potential IRS digital asset audit, one that will likely uncover the full history of their digital asset holdings and transactions. And since the use of digital assets has become more accepted and less of a novelty among traditional businesses, these assets have increasingly come under scrutiny by the IRS. So, if you hold or transact in digital assets of any kind, consider taking the time and making the effort to conduct a thoughtful analysis and to maintain contemporaneous and robust documentation of all holdings and transactions.

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Endnotes

01. Internal Revenue Service (IRS), "[IRS announces sweeping effort to restore fairness to tax system with Inflation Reduction Act funding; new compliance efforts focused on increasing scrutiny on high-income, partnerships, corporations, and promoters abusing tax rules on the books,](#)" press release, September 8, 2023.
02. US Department of the Treasury, "[US Department of the Treasury, IRS release proposed regulations on sales and exchanges of digital assets by brokers,](#)" press release, August 25, 2023.
03. 3 Ibid.
04. By Treasury's own admission, "Although there are several existing information reporting provisions in the Code that do, or may, apply to dispositions of virtual currency and other digital assets, those provisions do not provide clear and comprehensive rules for consistent reporting of these dispositions." [Preamble to proposed regulations.](#)
05. IRC § 6501.
06. IRC 6501(e).



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