

Tax positions on crypto transactions

Preparing for the 2022 tax season

Though tax regulations specifically governing digital assets still don't exist, the taxation of digital assets is very real. Deloitte explores how you can apply current IRS rules to this emerging way of buying, selling, paying, and investing.

The IRS and the taxation of digital assets

Digital assets have established their place in many financial functions: acquisition of goods and services, employee compensation, charitable contributions, among others.

But one place they have yet to establish themselves—at least with much specificity—is in the US Internal Revenue Code.

The US government has still much to write in terms of tax rules specific to digital assets. For now, one pays taxes on transactions with these assets as one does on transactions with other types of property: reporting gains or losses each time the assets are used (if the value has changed since purchase). This may seem tedious and demanding for the user of digital assets who is filling out their Form 1040, but there's a lot at stake. A lack of familiarity and compliance with the existing rules may carry significant tax risk, in addition to interest and penalties.

The Form 1040 that taxpayers will be required to fill out this coming tax season will expand reporting

requirements from what was simply “virtual currency” to include all “digital assets.” This change is part of an effort to keep tabs on the financial activity generated by the proliferation of digital assets. According to the IRS, these holdings include “any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary [of the Treasury].” To be sure, these assets are relatively new—some barely a decade old and most only a few years.

The evolution of this reporting requirement serves as a clear signal to the digital asset owner and user that the US government is keenly aware of and is monitoring the evolutionary nature of crypto—and that it intends to continue to do so.

So, what do you need to know right now? To help ensure proper tax reporting and avoid any tax controversy related to your digital assets, it's critical that you take a hard look at seven key types of transactions.

Form 1040		Department of the Treasury—Internal Revenue Service		2022		OMB No. 1545-0074		IRS Use Only—Do not write or staple in this space.	
Filing Status Check only one box.		<input type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately (MFS) <input type="checkbox"/> Head of household (HOH) <input type="checkbox"/> Qualifying surviving spouse (QSS)							
		If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent:							
Your first name and middle initial		Last name				Your social security number			
If joint return, spouse's first name and middle initial		Last name				Spouse's social security number			
Home address (number and street). If you have a P.O. box, see instructions.						Apt. no.		Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse	
City, town, or post office. If you have a foreign address, also complete spaces below.				State		ZIP code			
Foreign country name		Foreign province/state/county		Foreign postal code					
Digital Assets		At any time during 2022, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) <input type="checkbox"/> Yes <input type="checkbox"/> No							

The latest draft of the Form 1040 includes the more-comprehensive term “digital assets” and broadens the scope of transactions covered.

Using digital assets like money

Not since the California gold rush has bartering been so widespread. Though paying for goods and services with digital assets may seem to be akin to paying with fiat currency,¹ it's completely different in the eyes of the IRS. Because the agency treats digital assets as property, a purchase or sale involving a digital asset is considered a barter transaction. Gain or loss is triggered when digital assets are used in a transaction. And that gain or loss is the difference between the fair market value of the digital asset at the time of the transaction and its tax basis (generally, the amount paid at the time you originally acquired the digital asset).

Let's say you acquired a bitcoin some years ago for \$100 and have held it as a capital asset (generally, for investment). Now, let's say that same bitcoin is valued at \$17,000. Were you to use part of that bitcoin to buy a \$5 cup of coffee, you'll need to report almost the entire cup of coffee as a capital gain because the actual basis portion of the total bitcoin you traded in the transaction would only be a few pennies.

What it means for you: We are simply not wired to think about reporting capital gains or losses on our taxes when we do something as mundane as buying a cup of coffee. Establishing the right tax accounting method to address this complexity requires careful planning. It's incumbent upon the transactor to keep clear, traceable records. You need to know which specific asset you're using to buy something—and its basis—to accurately report the gain or loss at tax time.

Without the right tax accounting methodology, correct reporting could prove frustrating and exceedingly complex.

(Think about the folks who “barter” as a primary payment method.) Contemporaneous documentation—tracking as you go—is critical.

New forms to look for

Legislation passed November 15, 2021, which included digital assets into two existing tax forms:

- **Section 6045:** Congressional legislation (the Infrastructure Investment and Jobs Act²) marks the first time the Internal Revenue Code recognized digital assets. It requires those who facilitate transactions involving digital assets to file Forms 1099 for digital asset sales similar to current securities reporting. These rules include a novel reporting requirement for digital asset transfers off-platform, necessitating a new Form 1099 to accomplish transfer reporting. Those facilitating digital asset transactions—“brokers”—are required to track the cost basis of “covered” digital assets to include in sale and transfer reporting, the deadline for which has been extended pending publication of final regulatory guidance.
- **Section 6050I:** Another form will require reporting by those who receive digital assets in exchange for goods and services for any transaction worth more than \$10,000 (on or after Jan. 1, 2024). This new reporting requirement will be similar to that of Form 8300—last updated in 2014³—which one files when depositing more than \$10,000 in cash at a bank, for example.

Employee compensation

Just as with the use of digital assets for transactions involving goods and services, their use for paying and receiving wages is similarly complicated from a tax perspective. This is true for current compensation and other forms, such as restricted token awards and restricted token units. If you're an employer that utilizes digital assets to remunerate employees, you are required to withhold and remit payroll taxes in the same manner as if you were paying in US currency.

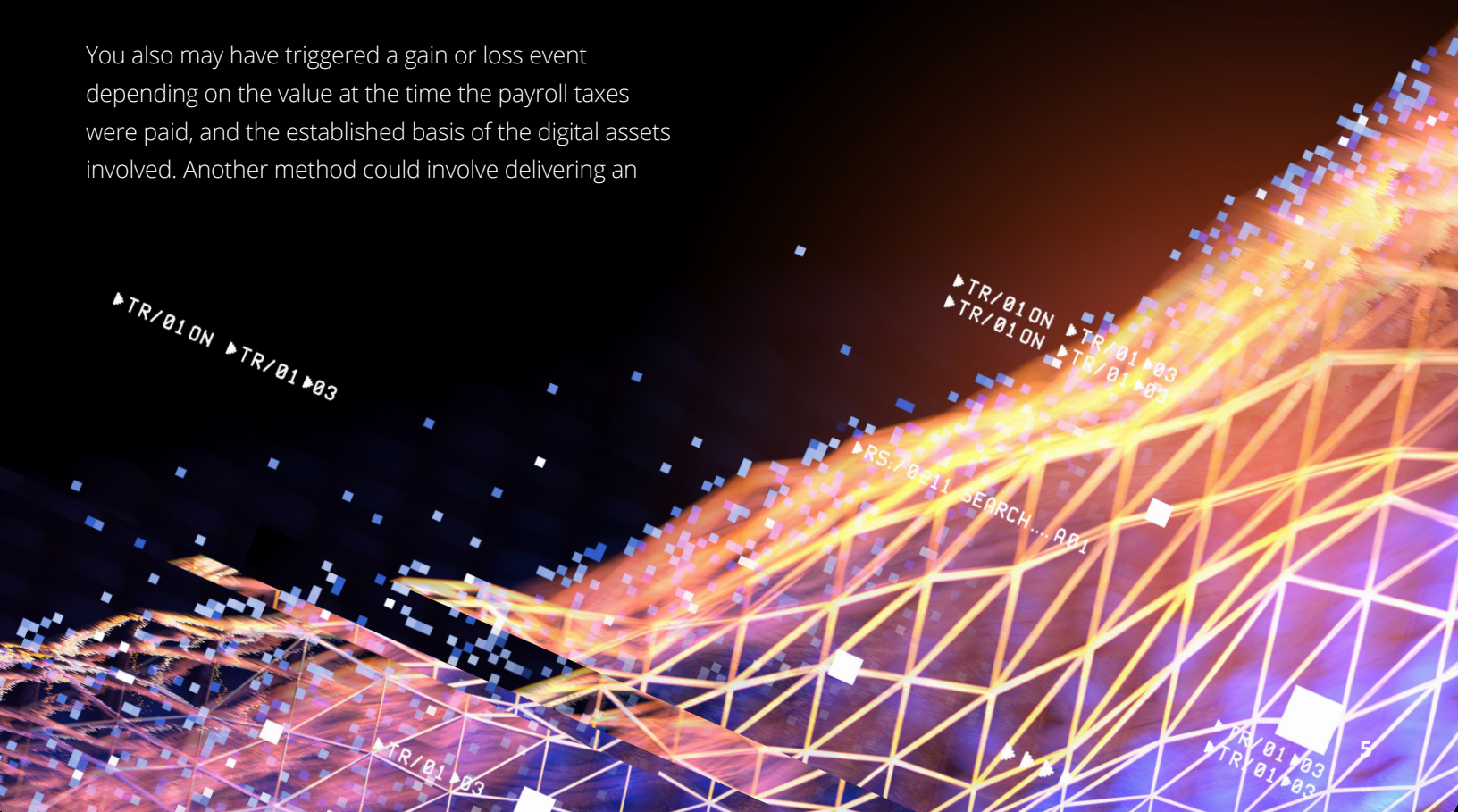
Because most states and the federal government do not accept virtual currency as a form of payment, you'll need to convert the withheld assets to fiat to pay the government. That seemingly innocuous transaction may well mean that you, the employer, effectively purchased and converted those digital assets, thereby establishing a basis that you can recover with a subsequent use (if not sold to acquire the necessary fiat to fulfill payroll tax withholding obligations).

You also may have triggered a gain or loss event depending on the value at the time the payroll taxes were paid, and the established basis of the digital assets involved. Another method could involve delivering an

amount of tokens, net of tax, to an employee with the employer using cash to satisfy payroll tax reporting and withholding obligations. Of course, the employee would still be subject to taxes on the full value of the compensation under this method. But it may ease the tax issues prompted by the employer's purchasing and delivering of tokens.

If you're the employee, you must establish a separate basis with each tranche of assets you receive as compensation.

What it means for you: For the employer, it's essential to maintain detailed, real-time documentation as you acquire, use, and distribute digital assets. For an employee, that same contemporaneous documentation of transactions is equally vital so they can reconcile future capital gains and losses.



Charitable contributions

The rules around charitable contributions using digital assets are the same as those for donations of property. The IRS allows individual donors a deduction for the donation of long-term capital gain property equal to the fair market value as determined by a qualified appraisal.

As a donor, you need to understand if the digital assets that you're contributing constitute "capital gain property." Currently, the IRS limits the amount of charitable deduction to the donor's basis for donated assets that are not capital gain property. For example, an NFT providing art property rights may not be capital gain property to the artist. The charitable deduction for the donation of that NFT by the artist after creation could be limited to the basis only.

What it means for you: As a charitable donor, you'll need to ask at least three questions:

- **Is the asset being transferred a donation of a partial interest?** You need to determine if your donation represents your entire interest in the property.
- **What is the value of the asset being transferred?** The fair market value is crucial for both you and your beneficiary. You are required to obtain a qualified appraisal for any asset with a value in excess of \$5,000.⁴
- **What type of charitable organization is the recipient?** The type of charity you choose to donate to is important. For example, if the charity is public,⁵ then whether the asset is used directly for the public charity's exempt purpose will factor into determining your charitable deduction.⁶

You'll need to obtain contemporaneous written acknowledgment of a donation from any charity to which you contribute more than \$250.



Staking rewards

There have been different points of view on how to classify staking rewards. Many in the industry chose to align with the IRS guidance on mining rewards stated in Notice 2014-21. That would mean treating staking rewards as income at the time they are earned or received.⁷

But of course, it's slightly more complicated than that. Not only are you receiving taxable income with each tranche's rewards, you're also regularly establishing basis in the new assets.

What it means for you: First, you need to determine if it's appropriate to treat your staking rewards as income when earned. Then, once again, when you dispose of your staking rewards, you need to make sure your contemporaneous tax accounting methodology is sound in tracking basis and recovery.

Limited guidance, in the form of FAQs, has been issued by the IRS with respect to basis tracking methods available for those partaking in digital asset transactions. The issued FAQs reference the use of specific identification of the assets (and the basis of such assets) used in transactions, if you have a means of identifying those assets used (e.g., by account, wallet address, etc.).

What is not clear however, is what steps you must take in order to appropriately identify the specific assets used. Further, transacting with self-custodied digital assets may have different considerations in identifying the assets used, as opposed to transacting on a centralized exchange. If you are unable to specifically identify the assets used in a transaction, the FAQs indicate that a First-In-First-Out ("FIFO") method may be used to recover basis in transactions. If you rely on the FIFO basis recovery methodology, you would account for transactions as if you were using the earliest acquired asset of that kind (e.g., BTC, ETH, etc.).

These nuances in basis tracking may be more relevant if you are participating in staking activities, given that staking rewards may be received in the same wallet address or account that holds the initially staked assets, all of which will likely have different tax bases. It is recommended that you consult with a tax adviser to ensure you are consistently applying appropriate tax accounting methods as they relate to both staking rewards and tax basis tracking.

Engagement with a decentralized exchange (DeX)

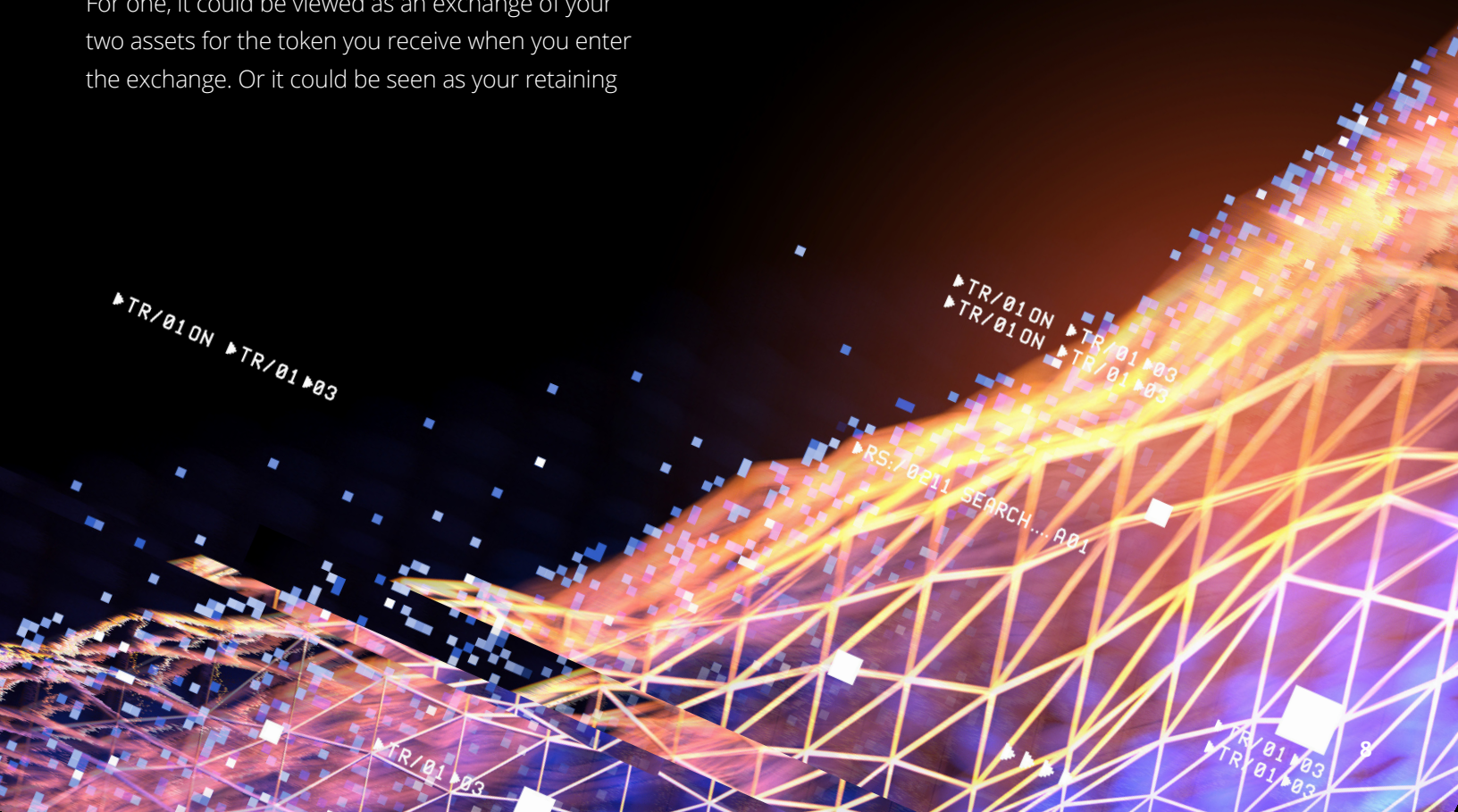
A DeX is a decentralized application that enables the sale or exchange of assets between two unknown parties, operating on a common ruleset as opposed to through a centralized exchange, matchmaker, or broker. You participate as a liquidity provider, whereby you typically deposit two different digital assets of equal value to a smart contract (liquidity pool) and receive a token representing your share of assets funded to that pool. Alternatively, you can simply use the DeX to acquire one of the assets supported by a liquidity pool, by sending the requisite amount of the other asset, as determined by the DeX algorithm.

Your participation in a DeX as a liquidity provider can be characterized in several ways for tax purposes, but typically there are two common approaches. For one, it could be viewed as an exchange of your two assets for the token you receive when you enter the exchange. Or it could be seen as your retaining

ownership of your asset when it goes into the exchange (and accounting for a pro-rata portion of third party “buy” transactions from the DeX).

Currently there is no specific guidance applicable to participation in a DeX. As such, it is recommended that you consult with your tax adviser to determine an appropriate treatment for these activities.

What it means for you: No matter how you characterize your DeX participation, there’s a strong chance that it was a taxable event at some point. You should exercise caution when participating in a DeX, understand your rights and obligations as a user, and maintain consistency in your chosen approach.



DeFi lending

The general operating model of DeFi lending protocols enables unknown parties to lend and borrow assets from each other. Typically, these utilize an over-collateralization model that requires borrowers to deposit digital assets in a lending pool on the DeFi lending platform so they can establish their collateral base. As such, if you are participating in DeFi lending, the first question to answer is whether funding the lending pool results in a recognition event for income tax purposes.

You may view this as a lending transaction, given that a party may generally withdraw the provided capital on demand (although this may be limited by both your “account liquidity” and the lending pool’s liquidity to support the withdrawal); however, lending transactions involving property are not always “non-recognition” events for tax purposes.

In fact, IRC 1058 is a specific exemption for the lending of securities that allows non-recognition treatment and is

not applicable to similar transactions using digital assets. As such, even formally papered loans of digital assets may result in a recognition event.

What it means for you: Rarely are there explicit terms and conditions for the users of DeFi protocols. Even more rarely do terms and conditions address tax issues directly. So, it’s on you (and your tax adviser) as a party to the transaction to understand the technological construction of the DeFi instrument and determine whether your participation would give rise to a recognition event.

If you participate in DeFi lending activities, it is recommended that you consult with a knowledgeable tax adviser to determine appropriate tax treatment of your DeFi lending activities.



Investments in early-stage crypto

Angel investors and others participating in early-stage digital asset startups frequently invest in both equity and in a token. Sometimes that takes the form of an equity instrument with a token kicker. Sometimes it's two instruments—one equity and one warrant to purchase a token. But many times, these early-stage companies have not yet developed a token, or they're not ready to release it yet.

There are myriad financial products that seek to put startup equity and tokens into the hands of investors. Consequently, the level of care exercised by the startups in designing these instruments varies considerably—both in terms of technological and legal design.

What it means for you: Exercise caution in the tax treatment of these instruments.

For warrant instruments, determine whether the warrant will be respected as a stand-alone instrument, effectively attaching the purchase price and exercise price of the warrant to the token when it is delivered. Although it may be helpful to have two separate agreements (equity and token), this may not be determinative in whether the constructs are truly independent. For instance, limitations on transferability, determination of tokens allotted to a warrant holder that are dependent on ownership of equity, among other factors may influence

whether these two instruments are truly independent. Alternatively, if the token were characterized as a distribution on equity of the company, that circumstance carries certain tax implications for the company and the recipient (akin to a distribution of appreciated property that can be characterized as a dividend).

For investors who enter into a Simple Agreement for Future Tokens (SAFT), the big question relates to when your holding period starts. Generally, your holding period for tax purposes starts on the date an asset is acquired. As such, if you acquired tokens via a SAFT arrangement, your holding period of the token will begin the date that token is received.

By understanding the structure and tax treatment of your investment from the outset, you can limit any unpleasant surprises should the IRS take an alternative position on the transaction. Keeping detailed records and an analysis of the intended tax treatment of the investments can help you cover your bases and avoid penalties if the IRS does take an opposing position.

Bottom line

What does all this mean? In short, more new forms, new types of transactions and new types of reporting to the IRS, all of which, in turn, may translate to more potential audits. To get this right, it's best to have a trusted adviser to guide you through this thicket of often unclear and uncertain regulation.

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Other factors to bear in mind

While the IRS currently does not issue digital asset-specific penalties, the agency is indeed increasing its scrutiny around these assets, which in turn raises users' risk of examination and existing penalties. A few things to bear in mind:

- The default limitation on assessments is three years under IRC 6501(a).⁸
- If a taxpayer under-reports gross income by more than 25%, the limitation on assessment is six years under IRC 6501(e).⁹
- In the case of fraud—when a user purposefully files a return with incorrect information to attempt to evade taxes—the IRS has unlimited time to assess.
- It's possible that failure to report ownership of digital assets by acknowledging them on your Form 1040 could subject you to this extended statute.
- The IRS is increasingly using John Doe summonses to find account holders.

Endnotes

1. Fiat currency refers to currency which is issued by a central bank
2. [Bipartisan Infrastructure Law \(P.L. 117-58\)](#)
3. [IRS Form 8300, Report of Cash Payments over \\$10,000 Received in a Trade or Business \(Rev. August 2014\).](#)
4. [§1.170A-16\(d\)\(1\)](#)
5. Public charity for this purpose includes donor advised funds, supporting organizations, private operating foundations, and exempt operating foundations.
6. [§170\(b\)\(1\)\(B\)](#)
7. [IRS Notice 2014-21.](#)
8. Legal Information Institute (LII), "[26 U.S. Code § 6501–Limitations on assessment and collection,](#)" accessed December 5, 2022.
9. [§170\(b\)\(1\)\(B\).](#)



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