

# UNCERTAINTY IN VIRTUAL CURRENCY TAXATION

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## I. INTRODUCTION

The popularity of virtual currency and crypto assets has increased tremendously in the recent years. In fact, “[t]he U.S. is among the countries that host the highest concentration of cryptocurrency and Bitcoin trading volume in the world.”<sup>1</sup> The Internal Revenue Service (“IRS”) issued its first guidance on virtual currency in 2014 in the form of a sub-regulatory Notice.<sup>2</sup>

The guidance came in the form of a Revenue Ruling and Frequently Asked Questions (“FAQs”) that apply to taxpayers holding virtual currency as a capital asset (together referred to as the “IRS guidance”).<sup>3</sup>

For the purposes of this Note, the terms virtual currency and cryptocurrency are used interchangeably.

The IRS defines *virtual currency* as:

[A]ny digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

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<sup>1</sup> Reuven S. Avi-Yonah & Mohanad Salaimi, *A New Framework for Taxing Cryptocurrencies* 2 (Univ. Mich. Pub. L. Rsch. Paper No. 22-014, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4071391](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4071391) [<https://perma.cc/YKH7-LHE7>].

<sup>2</sup> I.R.S. Notice 2014-21, 2014-16 I.R.B. 938; Avi-Yonah & Salaimi, *supra* note 1, at 17. The IRS released more guidance in October 2019, focused on hard forks and air drops, which are cryptocurrency techniques and beyond the scope of this note, for more information see sources cited *infra* note 36.

<sup>3</sup> Notice 2014-21, 2014-16 I.R.B. 938.

Digital assets are not real currency (also known as “fiat”) because they are not the coin and paper money of the United States or a foreign country and are not digitally issued by a government’s central bank.<sup>4</sup>

With new virtual currencies<sup>5</sup> bombarding the blockchain, the guidance related to virtual currency needs to evolve as well.<sup>6</sup> Currently, the IRS has some FAQs and Notices addressing the basic definitions and clarifying the treatment of various types of virtual currency transactions.<sup>7</sup>

The IRS Notice 2014-21 acknowledges that there are still unanswered questions pertaining to the taxation of virtual currency.<sup>8</sup> Taxpayers dealing in virtual currency need to be extra vigilant while filing their federal and state tax returns to properly document their transactions as the reporting requirements can be complicated.<sup>9</sup>

This Note will discuss the inadequate guidance on virtual currency and the tax law treatment of most popular virtual currency transactions such as staking and Non-Fungible Tokens (“NFTs”). This Note will also discuss the current foreign reporting requirements (FBAR and FATCA) for virtual currency held abroad and the challenges posed by the inadequate guidance. Finally, this Note will propose solutions to address some of the current challenges and uncertainties the taxpayers face.

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<sup>4</sup> *Digital Assets*, I.R.S. (Jan. 30, 2023), <https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets> [<https://perma.cc/V6DF-ZJC6>].

<sup>5</sup>

There are numerous types of cryptocurrencies which may be classified under distinct criteria. For example, cryptocurrencies may be classified based on whether they are connected to the real-world economy or not. Under this classification, cryptocurrencies are divided to two categories: The first category of cryptocurrencies is those used only in the virtual world and are not connected to real-world economy. An example is exchanging virtual content used in certain digital platforms such as virtual games.

The second category of cryptocurrencies is the one which meets the real-world economy. These cryptocurrencies can be a substitute for real currency in, for example, purchasing goods or services. . . . [T]he latter category . . . includes the major cryptocurrencies such as Bitcoin and Ether. Bitcoin constitutes the first cryptocurrency which was launched in 2008 and remains the most recognized cryptocurrency.

Avi-Yonah & Salaimi, *supra* note 1, at 4.

<sup>6</sup> Kyle Lydy, Comment, *The IRS Can Show Cryptocurrency Holders that Money Talks through Updated Guidance and Conditional Forgiveness*, 2021 MICH. ST. L. REV. 295, 295 (2021).

<sup>7</sup> E.g., *Digital Assets*, *supra* note 4; Notice 2014-21, 2014-16 I.R.B. 938; IRM Section 4.10.7.2.4.

<sup>8</sup> Notice 2014-21, 2014-16 I.R.B. 938.

<sup>9</sup> See Andrea S. Kramer, *The Confused State of Virtual Currency Taxation in 2020*, 98 TAXES 37, 51 (2020).

## II. CURRENT GUIDANCE ON VIRTUAL CURRENCY

The threshold issue is the lack of proper guidance issued by the IRS on virtual currency or the related transactions. The IRS first clarified its stance on virtual currency in 2014 in the form of a sub-regulatory Notice.<sup>10</sup> The IRS has also published forty-six FAQs regarding virtual currency on its website.<sup>11</sup> Additionally, the IRS expanded its guidance from 2014 by including Revenue Ruling 2019-24 and adding more FAQs.<sup>12</sup> In the past, the FAQs have been used to provide information about “run-of-the-mill topics, such as filing timelines, filing statuses,” how to check the status of a refund or an amended return, and so on.<sup>13</sup> Recently, the IRS has relied heavily on FAQs as they are an immediate source of information for the taxpayers to provide guidance on more technical and complicated issues.<sup>14</sup>

However, the taxpayers should be critical when relying on the FAQs. “FAQs are not published in the Internal Revenue Bulletin, are not treated as precedential or binding on the IRS and may be removed or changed by the IRS at any time (without any repository available to find prior versions of FAQs).”<sup>15</sup> National Taxpayer Advocate Erin M. Collins has described the “FAQ problem” as a “violation of the Taxpayer Bill of Rights, namely, the rights to be informed and to a fair and just tax system.”<sup>16</sup>

In the Government Accountability Office’s (“GAO”) Report, the IRS took the stance that “FAQs are illustrative of how longstanding tax principles apply to property transactions.”<sup>17</sup> The agency also clarified that it “does not take positions contrary to public FAQs.”<sup>18</sup> The

<sup>10</sup> See *Frequently Asked Questions on Virtual Currency Transactions*, I.R.S. (Jan. 13, 2023), <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [https://perma.cc/DC5B-R5U9] [hereinafter *FAQs on Virtual Currency Transactions*].

<sup>11</sup> *Id.*

<sup>12</sup> Rev. Rul. 2019-24, 2019-44 I.R.B. 1004.

<sup>13</sup> ROBERT S. HORWITZ & ANNETTE NELLEN, *FAQS: PROBLEMS WITH THE PROCESS OF INFORMAL GUIDANCE FROM THE INTERNAL REVENUE SERVICE*, TAX POL’Y, PRAC. & LEGIS. COMM. 2 (2012).

<sup>14</sup> *Id.*

<sup>15</sup> Andrew R. Robertson & Kevin Spencer, *IRS Provides Guidance on Reliance of FAQs for Penalty Protection Purposes*, TAX CONTROVERSY 360 (Oct. 18, 2021), <https://www.taxcontroversy360.com/2021/10/irs-provides-guidance-on-reliance-of-faqs-for-penalty-protection-purposes> [https://perma.cc/BN8X-FEVN].

<sup>16</sup> Annette Nellen, *Categorizing FAQs in the Guidance Sphere*, TAX ADVISER (Jan. 1, 2021), <https://www.thetaxadviser.com/issues/2021/jan/categorizing-irs-guidance-and-documents.html> [https://perma.cc/D6MG-9VTQ].

<sup>17</sup> U.S. GOV’T ACCOUNTABILITY OFF., GAO-20-188, *VIRTUAL CURRENCIES: ADDITIONAL INFORMATION REPORTING AND CLARIFIED GUIDANCE COULD IMPROVE TAX COMPLIANCE* (2020).

<sup>18</sup> *Id.*

statement is contrary to the agency's previous stance that FAQs are not legal authority.<sup>19</sup> On October 15, 2021, the IRS initially published a news release to further clarify its position on the legal authority of the FAQs.<sup>20</sup>

The news release does two important things. First, it gives the FAQs some standing in the realm of the sub-regulatory guidance.<sup>21</sup> The IRS has enhanced the information reporting process by issuing the FAQs via "Fact Sheets."<sup>22</sup> IRS's FAQs are not binding authority but "[a]ccording to the press release, Fact Sheets are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return."<sup>23</sup>

Second, the news release addresses the "archival storage" of the previously published and deleted FAQs.<sup>24</sup> Specifically, the news release focuses on a taxpayer's "good-faith" and "reasonable reliance" as a defense against negligence or accuracy related penalty.<sup>25</sup> IR 2021-202 was accompanied by a new policy, "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," that is published on the IRS website.<sup>26</sup> The language in the news release and the new policy on the IRS website are quite similar. The policy recognizes the non-precedential nature of the FAQs but, like the news release, gives weightage to "a

<sup>19</sup> See IRM 4.10.7.2.4.

<sup>20</sup> See *News Release IR-2021-202*, I.R.S. (Aug. 19, 2022), <https://www.irs.gov/newsroom/irs-updates-process-for-frequently-asked-questions-on-new-tax-legislation-and-addresses-reliance-concerns> [<https://perma.cc/UQT5-KZA6>] ("FAQs are being issued to provide general information to taxpayers and tax professionals as expeditiously as possible. Accordingly, these FAQs may not address any particular taxpayer's specific facts and circumstances, and they may be updated or modified upon further review. Because these FAQs have not been published in the Internal Revenue Bulletin, they will not be relied on or used by the IRS to resolve a case . . . a taxpayer who reasonably and in good faith relies on these FAQs will not be subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax.").

<sup>21</sup> See Frank G. Colella, *The New and Decidedly Improved IRS 'Fact Sheet' Frequently Asked Questions*, 100 TAXES 49, 50–51 (2022).

<sup>22</sup> *Id.* at 51. The pandemic has exacerbated the already complicated situation both for the IRS and the taxpayers. See *id.* at 49 & 53 n.5.

<sup>23</sup> Christina Jones, Mary Monahan & Jonathan Sambur, *IRS Updates Process for FAQs on New Tax Legislation and Addresses Taxpayer Reliance Concerns*, JD SUPRA (Nov. 11, 2021) (citing *News Release IR-2021-202*, *supra* note 20), <https://www.jdsupra.com/legalnews/irs-updates-process-for-faqs-on-new-tax-3533917/> [<https://perma.cc/XE29-D8EG>].

<sup>24</sup> See Colella, *supra* note 21, at 51.

<sup>25</sup> *Id.* at 52.

<sup>26</sup> *News Release IR-2021-202*, *supra* note 20.

taxpayer's reasonable reliance on an FAQ" in determining certain accuracy related penalties.<sup>27</sup>

Reasonable reliance, according to the IRS, refers to reliance that was reasonable and based on all the relevant facts and circumstances.<sup>28</sup> Such reliance is considered "a valid reasonable cause defense" against "a negligence penalty or other accuracy related penalty."<sup>29</sup>

The news release and the policy provide important benefits to taxpayers, especially when they rely on FAQs to take a position contrary to the IRS. Taxpayers can now have a reduced penalty exposure if they can show "reasonable cause" and "good-faith" reliance.<sup>30</sup> The policy and news release mention that the relief does not apply to all the penalties.<sup>31</sup> Furthermore, taxpayers must exercise caution in case the FAQ turns out to be an inaccurate statement of law.<sup>32</sup> In such a scenario, the existing law will govern and the taxpayer may end up with additional penalties.<sup>33</sup>

The news release states that "[i]n addition to significant FAQs on new legislation, the IRS may apply this updated [Fact Sheet] process in other contexts, such as when FAQs address emerging issues."<sup>34</sup> The IRS has already published forty-six FAQs related to virtual currency transactions.<sup>35</sup> It is unclear whether the guidance in the news release and the policy will apply to the already published FAQs. In addition, it is unclear if the outdated versions of the FAQs will be archived.

Confusion surrounding the complexities of the virtual currency technology has contributed to the underreporting of income in many instances.<sup>36</sup> This leaves the unsophisticated taxpayers confused and in a state of disarray. The volatility of the cryptocurrency market—especially during the last two years—has posed challenges to ensure that the agency is able to keep up with proper guidance and

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<sup>27</sup> See Jones et al., *supra* note 23.

<sup>28</sup> *News Release IR-2021-202*, *supra* note 20.

<sup>29</sup> *Id.*

<sup>30</sup> Jones et al., *supra* note 23; see also Treas. Reg. § 1.6664-4(b) (as amended in 2003).

<sup>31</sup> See Jones et al., *supra* note 23.

<sup>32</sup> See *id.*

<sup>33</sup> See *id.*

<sup>34</sup> *News Release IR-2021-202*, *supra* note 20.

<sup>35</sup> See *FAQs on Virtual Currency Transactions*, *supra* note 10.

<sup>36</sup> Lydy, *supra* note 6, at 298 (citing Nikhilesh De, *US Lawmakers Ask IRS to Clarify Crypto Tax Rules Around Airdrops, Forks in New Letter*, COINDESK (Sept. 13, 2021, 7:52 AM), <https://www.coindesk.com/us-lawmakers-ask-irs-to-clarify-crypto-tax-rules-around-airdrops-forks-in-new-letter> [<https://perma.cc/QXX4-KB4J>]); see also Lydy, *supra* note 6, at 298, n.9 ("stating that 2019 IRS guidance still left many cryptocurrencies taxation questions unanswered").

regulations.<sup>37</sup> Failure to accurately report or to underreport carries steep civil penalties along with criminal charges in some cases.<sup>38</sup>

For tax year 2020 the IRS moved the cryptocurrency question from Schedule 1 of the Form 1040, where it was in 2019, to the much more prominent position of Page 1 of the Form 1040 itself. . . . The question reads as follows: “At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?”

. . . .

On March 2, 2021 the IRS issued new guidance . . . that states “If your transactions involving virtual currency during 2020 were purchases of virtual currency with real currency, you are not required to answer yes to the Form 1040 question.”<sup>39</sup>

While this disclosure makes reporting easier, it also shows “the disconnect between the instructions and the FAQs—with a lack of formal guidance.”<sup>40</sup>

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<sup>37</sup> See *id.* at 297–98.

On Christmas Day 2015, one Bitcoin was trading for \$419. About two years later, on December 15, 2017, the value of a Bitcoin was \$19,650. At Christmas day of that year the price fell to \$15,075 (losing about a quarter of its value in just ten days). On December 15, 2018, a Bitcoin was trading at \$3,183. By Christmas 2020, the price had increased to \$24,400. All the above prices are approximate as they often vary significantly within the course of a day or even a few hours.

Avi-Yonah & Salaimi, *supra* note 1, at 7, n.32 (citing ESWAR S. PRASAD, *THE FUTURE OF MONEY: HOW THE DIGITAL REVOLUTION IS TRANSFORMING CURRENCIES AND FINANCE* 131 (2021)).

<sup>38</sup> Casey W. Baker & Ralph E. McKinney, Jr., *Cryptocurrency and Federal Tax Enforcement*, A.B.A. BUS. L. TODAY (June 8, 2021), [https://www.americanbar.org/groups/business\\_law/publications/blt/2021/06/fed-tax-enforcement/?login](https://www.americanbar.org/groups/business_law/publications/blt/2021/06/fed-tax-enforcement/?login) [<https://perma.cc/MCU7-G2VR>]. “An Accuracy-Related Penalty applies if you underpay the tax required to be shown on your return. Underpayment may happen if you don’t report all your income or you claim deductions or credits for which you don’t qualify.” *Accuracy-Related Penalty*, I.R.S. (Jan. 30, 2023), <https://www.irs.gov/payments/accuracy-related-penalty> [<https://perma.cc/9MK4-7T8H>].

<sup>39</sup> Amber Gray-Fenner, *IRS Adds New Guidance but Form 1040 Cryptocurrency Question Is Still Causing Confusion*, FORBES (Mar. 5, 2021, 8:57 AM), <https://www.forbes.com/sites/ambergray-fenner/2021/03/05/irs-adds-new-guidance-but-form-1040-cryptocurrency-question-is-still-causing-confusion/?sh=2b41b57699a2> [<https://perma.cc/P85T-QEYT?type=image>].

<sup>40</sup> See Kelly Phillips Erb, *IRS Changes its Position on Frequently Asked Questions*, BLOOMBERG TAX (Oct. 21, 2021, 4:45 AM), <https://news.bloombergtax.com/tax-insights-and-commentary/irs-changes-its-position-on-frequently-asked-questions> [<https://perma.cc/5M8V-DHQ6>].

The new infrastructure bill<sup>41</sup> signed on November 15, 2021, contained legislation pertaining to new reporting requirements for virtual currency.<sup>42</sup> “The new law will require the brokers . . . to issue a 1099-B” and “notify the IRS directly of crypto transactions.”<sup>43</sup> The law extends traditional reporting requirements for certain transactions involving over \$10,000 in physical cash transactions involving a newly defined category of “digital assets,” including cryptocurrencies.<sup>44</sup>

Section 6050I requires businesses that “receive” over \$10,000 in cash (or other untraceable instruments like cashiers’ checks and money orders) to file a Form 8300 with the IRS, which includes the name, address, and taxpayer identification number, among other information, of both the payer and the beneficiary (usually the recipient) of the transaction. Because the “receipt” of physical cash generally involves an in-person transaction, Section 6050I historically has been applied mainly to transactions involving the in-person purchase of goods or services, such as when a person pays cash for jewelry, a car, or legal representation.<sup>45</sup>

Violation of this law is considered “a felony punishable for up to five years in prison.”<sup>46</sup> Those who oppose the law fear that the law will expand the government’s reach and “warrantless surveillance[.]” proponents of the law argue that it is a much-needed step in regulating the digital transactions.<sup>47</sup>

<sup>41</sup> H.R. Con. Res. 3684, 117th Cong., 135 Stat. 429 (2021).

<sup>42</sup> See John Puterbaugh, *Two Things Crypto Investors Should Know About the Infrastructure Bill President Biden Signed*, NEXT ADVISOR (May 3, 2022), <https://time.com/nextadvisor/investing/cryptocurrency/infrastructure-bill-crypto-taxes/> [https://perma.cc/8K9G-KG8E].

<sup>43</sup> *Id.*

<sup>44</sup> See H.R. Con. Res. 3684; see also I.R.C. § 6050I.

<sup>45</sup> *Infrastructure Bill’s New Reporting Requirements May Have Sweeping Implications for Cryptocurrency Ecosystem*, GIBSON DUNN (Nov. 18, 2021) (citing Treas. Reg. § 1.6050I-1), <https://www.gibsondunn.com/infrastructure-bills-new-reporting-requirements-may-have-sweeping-implications-for-cryptocurrency-ecosystem/> [https://perma.cc/SJE4-7CGF].

<sup>46</sup> Marta Belcher, *Tucked Inside Biden Infrastructure Bill: Unconstitutional Crypto Surveillance*, COINDESK (Nov. 7, 2022), <https://www.coindesk.com/layer2/privacyweek/2022/01/25/tucked-inside-biden-infrastructure-bill-unconstitutional-crypto-surveillance/> [https://perma.cc/Q4B8-KEJD].

<sup>47</sup> Compare *id.*, with Kelsey Warner, *How Cryptocurrency Became a Controversial Part of the \$1 Trillion US Infrastructure Bill*, NAT’L (Aug. 9, 2021), <https://www.thenationalnews.com/business/cryptocurrencies/2021/09/21/how-cryptocurrency-became-a-controversial-part-of-the-1-trillion-us-infrastructure-bill/> [https://perma.cc/SY23-NYMR].

Taxpayers have to be cautious while reporting their virtual currency transactions due to the lack of comprehensive guidance. The 2014 and 2019 Revenue Rulings do not “address the administrative challenge associated with the taxation of cryptocurrencies.”<sup>48</sup> They do not address the different kinds of virtual currency transactions—including staking rewards and NFTs—and foreign reporting requirements.<sup>49</sup>

Even though the IRS is trying to keep up with the volatility and changes in virtual currency transactions, it is still far behind. Although the limited guidance is a start, it is not enough for the IRS to catch up with this evolving technology. However, this has not stopped IRS’s enforcement actions.<sup>50</sup> Failure to properly disclose cryptocurrency can trigger both civil and criminal penalties under the Internal Revenue Code (“IRC”).<sup>51</sup> Furthermore, the backlog attributable to COVID<sup>52</sup> and “the lack of documentation . . . available to the IRS” has exacerbated the potential for inaccurate reporting.<sup>53</sup>

### III. VIRTUAL CURRENCY TRANSACTIONS

#### A. *Staking Rewards*

One area in need of guidance for virtual currency transactions relates to “staking rewards.” “Staking is the process of delegating or locking up crypto holdings to earn rewards.”<sup>54</sup> “Staking is available with cryptocurrencies that use a proof-of-stake model.”<sup>55</sup>

<sup>48</sup> Avi-Yonah & Salaimi, *supra* note 1, at 19.

<sup>49</sup> *See id.* at 20, 58–60.

<sup>50</sup> *See* Guinevere Moore, *Virtual Currency Reality: The IRS Crack down on Cryptocurrency*, 21 J. TAX PRAC. & PROC. 37, 39 (2019) [hereinafter *Moore*]; *see also* Guinevere Moore, *Operation Hidden Treasure Is Here. If You Have Unreported Crypto, Get Legal Advice*, FORBES (Mar. 6, 2021), <https://www.forbes.com/sites/irswatch/2021/03/06/operation-hidden-treasure-is-here-if-you-have-unreported-crypto-its-time-to-get-legal-advice/?sh=3dcaff4439c9> [https://perma.cc/LY7Y-QWFB].

<sup>51</sup> *See* I.R.C. § 6663; *see also* I.R.C. § 7201.

<sup>52</sup> *See* David Lawder, *U.S. IRS Clears Massive Backlog of Unprocessed Paper Tax Returns*, REUTERS (Apr. 18, 2023, 5:02 AM), <https://www.reuters.com/world/us/us-irs-clears-massive-backlog-unprocessed-paper-tax-returns-2023-04-18/> [https://perma.cc/Y3DX-BFX3].

<sup>53</sup> Constance Crawford, Corinne L. Crawford & Glenn C. Vallach, *The Confusing World of Cryptocurrency and Tax Compliance Issues*, 14 J. ECON. & BEHAV. STUD. 1, 2 (2022).

<sup>54</sup> Sam Becker, *What to Know About Staking—the Process of Locking Up Crypto Holdings to Earn Rewards and Interest*, BUS. INSIDER (July 12, 2022, 1:55 PM), <https://www.businessinsider.com/personal-finance/staking-crypto#:~:text=Crypto%20staking%20involves%20%22locking%20up,of%20additional%20coins%20or%20tokens> [https://perma.cc/55T3-D5J8].

<sup>55</sup> Carrie Brandon Elliot, *Tax Guidance on Digital Assets Seen as High Priority*, TAX NOTES FED. (Aug. 22, 2022, 11:24 AM), <https://www.taxnotes.com/tax-notes-today-federal/compliance/guidance-digital-assets-seen-high->



Proof of stake is a consensus mechanism, or a way for a blockchain to validate transactions. The nodes in a blockchain must agree on the present state of the blockchain and which transactions are valid. Staking is a method used by cryptocurrencies to verify transactions and involves committing cryptocurrency assets to support a blockchain network and confirm new transactions.<sup>56</sup>

The amount of staking rewards available in one transaction depends on the size of the stake and the holding period.<sup>57</sup>

Once a new token has been created by mining or staking, the next step is to determine how to report it for tax purposes.<sup>58</sup> The IRS has previously stated that when a taxpayer “mines” cryptocurrency, they must include the fair market value of the cryptocurrency received as a reward on the date received, and such mining may constitute “a trade or business subject to self-employment tax.”<sup>59</sup> Section 61 of the IRC defines gross income as “income from whatever source derived.”<sup>60</sup> If we consider staking rewards as interest payments, they should be included in gross income under Section 61(a)(4).<sup>61</sup> In addition, if we consider staking rewards as compensation for services, they should be included in gross income under Section 61(a)(1).<sup>62</sup> In other words, it is crucial to understand how to report earnings from staking rewards, and it helps to understand and report the income under the correct category.

In the absence of any specific guidance, the closest available is the guidance on mining income issued on Notice 2014-21.<sup>63</sup> The notice contains specific guidance on mining and when the mining income

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priority/2022/08/22/7dyfn?highlight=proof%20of%20stake%20and%20work  
[https://perma.cc/G8ZB-48KD].

<sup>56</sup> *Id.*

<sup>57</sup> Omri Marian, *Law, Policy, and the Taxation of Block Rewards*, 175 TAX NOTES FED., 1493, 1493 (2022).

<sup>58</sup> *See id.*

<sup>59</sup> Notice 2014-21, 2014-16 I.R.B. 938.

<sup>60</sup> I.R.C. § 61.

<sup>61</sup> Phil Gaudiano, *Why We Still Need Guidance on Staking Rewards Taxation*, COINDESK (Mar. 14, 2022, 3:30 PM), <https://www.coindesk.com/layer2/2022/02/25/why-we-still-need-guidance-on-staking-rewards-taxation/> [https://perma.cc/3QUV-QAQ4].

<sup>62</sup> *Id.*

<sup>63</sup> Shehan Chandrasekera, *IRS May Not Tax Passive Income from Holding Crypto Right Away*, FORBES (Feb. 3, 2022, 10:24 AM), <https://www.forbes.com/sites/shehanchandrasekera/2022/02/03/irs-may-not-tax-passive-income-from-holding-crypto-right-away/?sh=538de307799e> [https://perma.cc/K9VS-JW3N].

should be reported on the taxes.<sup>64</sup> However, “[s]taking results in creation of new property” and, based on Treas. Reg. Section 1.61-3(a), staking rewards should not be taxed until they are sold.<sup>65</sup>

A recent example of this is *Jarrett v. United States*,<sup>66</sup> where Jarrett engaged in staking and created new blocks of Tezos tokens.<sup>67</sup> In 2019, Jarrett and his wife filed a joint return where they claimed the staking rewards as ordinary income and paid appropriate tax on it.<sup>68</sup> In 2020, however, they “filed an amended tax return, asserting that their staking rewards were not income subject to tax and requested a refund from the IRS in the amount of \$3,793.”<sup>69</sup> The Jarretts sued the IRS.<sup>70</sup> They “received a letter from the U.S. Department of Justice” stating that they were entitled to a full refund plus interest.<sup>71</sup> However, “[t]he Jarretts rejected the refund offer because

<sup>64</sup> *Id.*

<sup>65</sup> *See id.*

<sup>66</sup> *Jarrett v. United States*, No. 21-cv-00419, 2022 U.S. Dist. LEXIS 178743 (M.D. Tenn., Sept. 30, 2022).

<sup>67</sup> The Jarretts argued that staking is akin to a baker making a cake, which isn’t taxable until it’s sold. Randy Buchanan, Sarah E. Paul & Michael Resnick, *Stake Your Claim: Taxpayers Claim the Creation of Cryptocurrency Is Akin to Baking a Cake and Non-Taxable*, EVERSLEDs SUTHERLAND (June 22, 2021), <https://us.eversheds-sutherland.com/NewsCommentary/Legal-Alerts/242908/Stake-your-claim-Taxpayers-claim-the-creation-of-cryptocurrency-is-akin-to-baking-a-cake-and-non-taxable> [https://perma.cc/6VDJ-Q95G]. The Jarretts stated in their complaint that the modern standard for gross income under the Supreme Court case *Commissioner v. Glenshaw Glass Co.* “would not tax the baker solely because he bakes a cake, or the writer solely because she writes a book.” Complaint at 6, *Jarrett*, 2022 LEXIS 178743 (No. 21-cv-0049). “The IRS’s refund offer has generated considerable speculation about how the IRS treats staking rewards[]” since they are not addressed in the FAQs. Pallav Raghuvanshi & Shira Peleg, *Recent Court Case Leaves Many Speculating on the Taxation of Staking Rewards*, LEGACY ADVISORS (Feb. 16, 2022), <https://www.gtlaw-legacyadvisors.com/2022/02/a-recent-court-case-leaves-many-speculating-on-the-taxation-of-staking-rewards> [https://perma.cc/D9QP-5GZ3]. Some experts opine that in line with the tax treatment applicable to mining rewards, the IRS argued that Jarrett received the tokens as payment for successfully validating new transactions for the blockchain. *See, e.g.*, Buchanan et al., *supra*. Thus, those tokens were taxable on receipt. In addition, the mere proposal of refund offers should not “be relied on as precedent” and “[t]axpayers engaged in staking should consult their tax advisors” about their potential liabilities. Raghuvanshi & Peleg, *supra*. While the tax community eagerly waited for the outcome of this case and expected a precedent to be set, the government took a stance that if it agrees to pay back the refund and interest, there is no longer any relief requested from the Court. Theresa Schliep, *Couple Can’t Challenge Crypto Taxes After Getting Refund*, LAW 360 (Oct. 4, 2022, 4:08 PM), [https://www.law360.com/tax-authority/federal/articles/1536558?utm\\_source=shared-articles&utm\\_medium=email&utm\\_campaign=shared-articles](https://www.law360.com/tax-authority/federal/articles/1536558?utm_source=shared-articles&utm_medium=email&utm_campaign=shared-articles) [https://perma.cc/8W7S-X5AE]. The government argued that what Plaintiffs really sought was an advisory opinion. *Id.*; *Jarrett*, 2022 U.S. Dist. LEXIS 178743, at \*14. And since this the court lacked the jurisdiction to issue advisory opinions, the action must be dismissed under Fed. R. Civ. P. 12(b)(1) for lack of jurisdiction. *Jarrett*, 2022 U.S. Dist. LEXIS 178743, at \*14–15.

<sup>68</sup> Raghuvanshi & Peleg, *supra* note 67.

<sup>69</sup> *Id.*

<sup>70</sup> *See id.*

<sup>71</sup> *Id.*

the IRS did not provide a reason for the refund and left open the issue of whether the creation of tokens through staking is a taxable event.”<sup>72</sup>

On September 30, 2022, the United States District Court for the Middle District of Tennessee declared the plaintiff’s claim for relief was moot and granted the United States’ motion to dismiss.<sup>73</sup> The court stated that the Jarretts were seeking an advisory opinion and which the court could not provide.<sup>74</sup> Given that the Court has refused to issue an opinion on the matter, the IRS position regarding the staking rewards taxation “remains unclear.”<sup>75</sup>

Without any guidance, it is difficult to understand how the IRS characterizes gains or losses from the staking rewards.<sup>76</sup> Reuven Avi-Yonah and Mohanad Salaimi have argued that income from staking rewards should be characterized as “interest income.”<sup>77</sup> They reason that staking rewards are similar to interest earned in a deposit account, which primarily depends on the holding period and the amount of deposit.<sup>78</sup> In essence, they argue that the income from staking rewards should be considered as income from a passive investment, which should be taxable upon realization.<sup>79</sup>

The lack of guidance or information regarding the staking rewards in the FAQs, Notices, and Revenue Rulings, has left the unwary taxpayer to rely on any available source of information.<sup>80</sup> Another issue that the *Jarrett* case highlights is that the Tezos tokens—and cryptocurrency in general—“do[] not fall neatly into these [income] categories.”<sup>81</sup> It is administratively burdensome and complex to

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<sup>72</sup> *Id.*

<sup>73</sup> *Jarrett*, 2022 U.S. Dist. LEXIS 178743, at \*14–15.

<sup>74</sup> Schliep, *supra* note 67 (quoting *Jarrett*, 2022 U.S. Dist. LEXIS 178743, at \*14).

<sup>75</sup> See Avi-Yonah & Salaimi, *supra* note 1, at 2, 33.

<sup>76</sup> See *id.* at 7, 14–15.

<sup>77</sup> *Id.* at 31 (“The reward that the stakers receive for depositing or lending out the tokens to the network is analogous to the interest charge for the mentioned deposit. In general, in an interest-earning deposit, the interest amount is calculated based on the amount of the deposit and the length of time of the deposit. It works the same way in the staking process. The more tokens the participant stakes, and the more time passed, the more he earns in Staking Rewards. All stakers receive a reward in the native crypto of the specific blockchain, which is generally distributed in the network in proportion to each staker’s stake. Thus, Staking Rewards, fundamentally, are similar to interest income on a deposit and should be characterized as such for tax purposes.”).

<sup>78</sup> *Id.*

<sup>79</sup> See *id.*

<sup>80</sup> See Horwitz, *supra* note 13, at 23–41.

<sup>81</sup> Amanda Parsons, *Cryptocurrency, Legibility, and Taxation*, 72 DUKE L.J. ONLINE 1, 2–3 (2022).

classify Mr. Jarrett's income, as it involves distinct activities such as baking and staking.<sup>82</sup>

### *B. Proof-of-Work Transactions*

Proof-of-stake and proof-of-work ("PoW") are the two main methods of validation.<sup>83</sup> Mining is different from staking in that it is a byproduct of the PoW mechanism, whereas staking is a byproduct of proof-of-stake mechanism.<sup>84</sup> "Under the PoW method, 'the right to validate new transactions and add them to the blockchain is allocated to so-called miners in exchange for finding an acceptable solution to an arbitrary cryptographic puzzle (the "work" or "mining").'"<sup>85</sup>

A PoW "algorithm is used to solve a complex mathematical problem for mining" bitcoin.<sup>86</sup> One of the main concerns in the PoW method is the use of high energy.<sup>87</sup> The complexity of the problems increases at each subsequent step, which in turn consumes more electricity and power.<sup>88</sup> Experts opine that mining has a massive negative impact on the environment.<sup>89</sup>

Generally, product of mining meets the *Glenshaw* standard and is considered gross income for the purposes of Section 61.<sup>90</sup> If the income constitutes a taxpayer's business or activity, it is subject to self-employment tax as well.<sup>91</sup> Another point of concern is whether the taxpayer can deduct expenses incurred during the mining of cryptocurrency. If the mining activity is a part of the taxpayer's trade or business, then the expenses are deductible under Section 162.<sup>92</sup> As these expenses are "ordinary and necessary" business expenses, they

<sup>82</sup> See *id.* at 9.

<sup>83</sup> Marian, *supra* note 57, at 1495.

<sup>84</sup> Oliver Barsby, *Crypto Mining Vs Staking: What's The Difference?*, PLANET CRYPTO (July 21, 2022, 8:29 AM), <https://www.gfityesports.com/cryptocurrency/crypto-mining-vs-staking-differences-profits-rewards-proof-of-stake-work/> [<https://perma.cc/593J-CV4B>].

<sup>85</sup> Marian, *supra* note 57, at 1495 (quoting N.Y. STATE BAR ASS'N TAX SECTION, REP. NO. 1461, CRYPTOCURRENCY AND OTHER FUNGIBLE DIGITAL ASSETS 42 (2022)).

<sup>86</sup> Md Rafiqul Islam, Muhammad Mahbubur Rashid, Mohammed Aatur Rahman, Muslim Har Sani Bin Mohamad & Abd Halim Bin Embong, *A Comprehensive Analysis of Blockchain-based Cryptocurrency Mining Impact on Energy Consumption*, 13 INT'L J. OF ADVANCED COMPUT. SCI. & APPLICATIONS, 590, 594 (2022); see also Travis Thompson, *Cryptocurrency: Overview and Tax Enforcement*, BLUE J TAX (Sept. 2022) ("Mining involves an intensive process of solving complex mathematical problems using energy, computing power, and other sophisticated hardware. It is considered a proof-of-work consensus mechanism.").

<sup>87</sup> Islam et al., *supra* note 86, at 590.

<sup>88</sup> See *id.* at 594.

<sup>89</sup> *E.g., id.*; Marian, *supra* note 57, at 1495.

<sup>90</sup> Marian, *supra* note 57, at 1496; see also I.R.C. § 61(a).

<sup>91</sup> See Thompson, *supra* note 86; see also Notice 2014-21, 2014-16 I.R.B. 939.

<sup>92</sup> See Avi-Yonah & Salaimi, *supra* note 1, at 25.

are eligible for capitalization or amortization.<sup>93</sup> In addition, cryptocurrency, “despite being categorized as property by the IRS, does not have a ‘useful life’ for purposes of depreciation or amortization,” therefore it is difficult to determine such costs.<sup>94</sup>

Thus, there is need for detailed guidance from the agencies not only regarding the right characterization of various cryptocurrencies, but also how the transactions are treated for tax purposes.

### C. Taxation of the NFTs

*“It’s all fun and games until the taxman comes knocking.”*<sup>95</sup>

Another uncharted territory is non-fungible tokens or NFTs.<sup>96</sup> The IRS has issued limited guidance on the taxation of NFTs.<sup>97</sup> “The popularity of [NFTs] is skyrocketing with artwork, music, and sports memorabilia being the tip of the digital assets iceberg.”<sup>98</sup> In essence, an NFT is a digital representation of ownership rights created on the blockchain.<sup>99</sup> With the growing popularity of the NFTs, everyone from artists to musicians to creative teenagers are looking to create “one-of-a-kind” content and authenticate it on the blockchain.<sup>100</sup> While it may seem a very exciting and creative venture, one thing to keep in mind is taxes; any transaction on the blockchain is a reportable transaction.<sup>101</sup>

Due to confusing guidance from the IRS, the unwary taxpayers are left to rely on “tax help and education from” internet-based education

<sup>93</sup> *Id.*

<sup>94</sup> *See id.*

<sup>95</sup> Sam Sutton, *If You Thought NFTs Were Crazy, Wait Til You See How They’re Taxed*, POLITICO (Mar. 22, 2022, 11:00AM), [www.politico.com/news/2022/03/22/like-grabbing-smoke-crypto-collectibles-confound-taxpayers-00017779](https://www.politico.com/news/2022/03/22/like-grabbing-smoke-crypto-collectibles-confound-taxpayers-00017779) [https://perma.cc/W9GS-52SX].

<sup>96</sup> *See, e.g.,* CRYPTOPUNKS, <https://www.larvalabs.com/cryptopunks/details/3100> [https://perma.cc/VE9D-3NSM]; *see also* Mark Roddy, *Investing in NFTs: Why Can Pixelated Images Be Worth Millions of Dollars?*, HOLON (Sept. 7, 2021), <https://holon.investments/investing-in-nfts-why-can-pixelated-images-be-worth-millions-of-dollars/> [https://perma.cc/42G5-LYY3] (“In March [2021], . . . Cryptopunk #3100 an NFT, sold for a staggering \$US7.58 million.”); Lisa Goldman, *NFTs Draw Scrutiny from IRS*, BERDON LLP (Aug. 19, 2021), <https://www.berdonllp.com/nfts-draw-scrutiny-from-irs/> [https://perma.cc/CMT9-QTJP].

<sup>97</sup> Goldman, *supra* note 96.

<sup>98</sup> *Id.*

<sup>99</sup> *See* Erin Fennimore, *NFT Tax Guide: What Creators and Investors Need to Know about NFT Taxes*, TAXBIT, (June 9, 2021), <https://taxbit.com/blog/nft-tax-guide-what-creators-and-investors-need-to-know-about-nft-taxes> [https://perma.cc/4Y6E-LLMU]; *see also* Goldman, *supra* note 96.

<sup>100</sup> Fennimore, *supra* note 99.

<sup>101</sup> *See id.*

blogs—“Reconcile and CoinDesk.”<sup>102</sup> The available virtual guidance on the NFTs suggests that the taxes depend on how the NFT was acquired.<sup>103</sup> If a taxpayer creates an NFT and sells it on a virtual marketplace, like OpenSea, it is taxed as ordinary business income and is also subject to self-employment taxes.”<sup>104</sup> Alternatively, if a taxpayer sells an NFT that they previously bought as an investment, it is taxed as capital gains.<sup>105</sup>

For a taxpayer who creates an NFT, it qualifies as an “ordinary asset” if the taxpayer used their “personal efforts” in producing the NFT.<sup>106</sup> It is also an ordinary asset “if it is part of the creator’s stock in trade, of a kind of property included in inventory, or held for sale to customers in the ordinary course of the creator’s trade or business.”<sup>107</sup> The ordinary income from such NFTs in the hands of the taxpayers can be offset by “ordinary and necessary expenses,” which are deductible expenses if “paid or incurred” by a taxpayer “in carrying on any trade or business” of creating and selling NFTs.<sup>108</sup> On the other hand, the NFTs held for investment purposes are subject to capital gains/loss treatment.<sup>109</sup> “Because NFTs are intangible assets, taxpayers holding NFTs for investment can amortize their adjusted basis in their NFTs.”<sup>110</sup>

Many argue an NFT qualifies “as a work of art and . . . a tangible asset . . . under § 408(m)(2).”<sup>111</sup> In that case, “the IRS could impose a higher rate of 28%” for gains involving the NFT.<sup>112</sup> The platforms that allow buying and selling of the NFTs “can report a sale” but

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<sup>102</sup> See Jaimin Desai, *5 Things to Remember When Paying Your NFT Taxes*, NASDAQ (Feb. 22, 2022, 10:33 AM), <https://www.nasdaq.com/articles/5-things-to-remember-when-paying-your-nft-taxes> [<https://perma.cc/5YDR-DMF4>].

<sup>103</sup> See *Taxation of the Purchase and Sale of NFTs*, MCDERMOTT WILL & EMERY (Jan. 11, 2022), <https://www.mwe.com/insights/taxation-of-the-purchase-and-sale-of-nfts/> [<https://perma.cc/D535-CCT4>].

<sup>104</sup> Desai, *supra* note 102; see Moore, *supra* note 50, at 38 (“Virtual currency that is received in exchange for services or goods is reportable as ordinary income, and is subject to self-employment tax.”).

<sup>105</sup> *Taxation of the Purchase and Sale of NFTs*, *supra* note 103.

<sup>106</sup> *Taxation of NFT Creators*, MCDERMOTT WILL & EMERY (Jan. 11, 2022), <https://www.mwe.com/insights/taxation-of-nft-creators/> [<https://perma.cc/X2HQ-Q6VR>].

<sup>107</sup> *Id.*; see I.R.C. § 1221(a)(1).

<sup>108</sup> See I.R.C. § 162(a).

<sup>109</sup> *Taxation of the Purchase and Sale of NFTs*, *supra* note 103; see generally I.R.C. § 1231(a)(3).

<sup>110</sup> *Taxation of the Purchase and Sale of NFTs*, *supra* note 103; see I.R.C. § 197(a), (c).

<sup>111</sup> Sofya Bakradze, *To Tax or Not to Tax or How to Tax: Tax Policy and Its Role in Cryptocurrency Adoption*, 28 RICH. J.L. & TECH. 340, 361 (2021).

<sup>112</sup> *Id.*

cannot accurately track the “buyer’s gain on the crypto used for the purchase.”<sup>113</sup>

Another issue is that the marketplaces for selling NFTs do not provide the taxpayers with informational forms such as a 1099-K or 1099-B.<sup>114</sup> This makes it difficult for the taxpayer to keep a track of their cost basis in order to accurately report income from the NFTs.<sup>115</sup>

#### *D. Taxation of Inherited Virtual Currency*

The IRS treats inherited virtual currency as an equivalent of “any inherited property [which] will only be subject to estate taxes if the value of the estate exceeds the IRS taxable threshold of \$11.7 million in 2021.”<sup>116</sup> Given the volatility in the virtual currency domain, it is crucial to anticipate the potential tax consequences of inheriting virtual currency.<sup>117</sup>

Currently, “[c]ryptocurrency is considered to be a probate asset,” meaning that it has “to go through the law before it can be transferred to [the] beneficiaries.”<sup>118</sup> The problem arises as “most popular crypto exchanges don’t support any type of beneficiary designation for crypto assets—such as transfer on death (TOD) or payable on death (POD) accounts—which are common ways to keep traditional assets out of probate.”<sup>119</sup>

Based on the evaluation of the estate, one might consider establishing an irrevocable trust and transferring the cryptocurrency to the trust.<sup>120</sup> It is important to note that, “as a general rule, the crypto . . . transferred to an irrevocable trust . . . won’t receive a basis adjustment (or set-up in basis) when you die.”<sup>121</sup>

<sup>113</sup> *Id.* at 362 (citing Walter Effross, Leonard Goodman, Anthony Pochesci & Jay A. Soled, *Tax Consequences of Nonfungible Tokens (NFTs)*, J. ACCT. (June 24, 2021), <https://www.journalofaccountancy.com/news/2021/jun/tax-consequences-of-nfts-nonfungible-tokens.html> [<https://perma.cc/8AGZ-P757>]).

<sup>114</sup> See Lydy, *supra* note 6, at 333–34.

<sup>115</sup> See *id.* at 333.

<sup>116</sup> Crawford et al., *supra* note 53, at 4.

<sup>117</sup> See Avi-Yonah, *supra* note 1, at 7.

<sup>118</sup> Apurba Pokharel & Krishna Dahal, *Crypto Inheritance Planning for HODLers: Methods to Safely Transfer Digital Assets To Beneficiaries*, (Aug. 7, 2022), <https://ssrn.com/abstract=4183803> [<https://perma.cc/ZH2T-GF54>].

<sup>119</sup> *Id.*

<sup>120</sup> See *id.*

<sup>121</sup> Allison L. Lee, *What Happens to Your Crypto Assets When You Die?*, KIPLINGER (Mar. 21, 2022), <https://www.kiplinger.com/investing/cryptocurrency/604424/what-happens-to-your-crypto-assets-when-you-die#:~:text=Like%20your%20real%20estate%20property,your%20beneficiaries%20after%20you%20die> [<https://perma.cc/E6WN-3SE9>].

The fair market value of cryptocurrency is to be calculated “by converting the virtual currency into U.S. dollars at the . . . [then current] exchange rate, in a reasonable manner that is consistently applied.”<sup>122</sup> There is clearly a need for more guidance in this area, as the value of cryptocurrency has been fluctuating every minute.

#### IV. FOREIGN REPORTING REQUIREMENTS OF VIRTUAL CURRENCY

There is a lack of guidance from the Treasury on the foreign reporting requirements for the virtual currency. “The IRS does not require antiques, jewels, cars, art, foreign currency, and real property that is held outside the country directly to be reported” on a Report of Foreign Bank and Financial Account (“FBAR”).<sup>123</sup> There has been tremendous confusion about whether assets held on foreign virtual currency exchange are required to be reported on FinCEN Form 114, FBAR. FinCEN responded to the confusion with a notice.<sup>124</sup>

Currently, the Report of Foreign Bank and Financial Accounts (FBAR) regulations do not define a foreign account holding virtual currency as a type of reportable account. For that reason, a foreign account holding virtual currency is not reportable on the FBAR (unless it is a reportable account under 31 C.F.R. 1010.350 because it holds reportable assets besides virtual currency). However, FinCEN intends to propose to amend the regulations implementing the Bank Secrecy Act (BSA) regarding reports of foreign financial accounts (FBAR) to include virtual currency as a type of reportable account under 31 CFR 1010.350.<sup>125</sup>

Given the lack of formal guidance on behalf of the Treasury, informal guidance on the reporting of virtual currency held as foreign assets could provide some much needed clarity. Virtual currency, especially Bitcoin, has dual characteristics of both a currency and a tangible asset, like jewelry, and is often held for investment purposes.<sup>126</sup> “Neither foreign currency nor jewels are required to be

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<sup>122</sup> Notice 2014-21, 2014-16 I.R.B. 938.

<sup>123</sup> Arash Kiadeh, *When Should Bitcoin Be Subject to FBAR?*, 5 CONTEMP. TAX J. 1, 4 (2016).

<sup>124</sup> See FinCEN Notice 2020-2 (Dec. 31, 2020).

<sup>125</sup> FinCEN Notice 2020-2 (internal citations omitted) (citing 31 Treas. Reg. § 1010.306(c) (2016); 31 Treas. Reg. § 1010.350(c) (2011)).

<sup>126</sup> Kiadeh, *supra* note 123, at 4.



reported on an FBAR if held directly, and therefore, [B]itcoin should not be either.”<sup>127</sup>

The inconsistency in the realm of virtual currency transactions for FBAR purposes creates a dangerous situation. Although the disclosure is not mandated, it is encouraged.<sup>128</sup> It has become even more important today as the United States Supreme Court heard a case on November 2, 2022, during the court’s October 2022–2023 Term on “an issue that has vexed taxpayers, the IRS, and numerous federal courts: how to calculate the penalty for a non-willful failure to file a Report of Foreign Bank and Financial Accounts, or FBAR.”<sup>129</sup> The main issue in the case involves the Bank Secrecy Act and the imposition of FBAR penalties.

The case is crucial to understand whether the IRS will impose the FBAR penalty “to a per form, per year FBAR penalty, a per account, per year violation, or a hybrid approach.”<sup>130</sup> The Court held that the penalty accrues on a per-report, not a per-account basis.<sup>131</sup>

Congress passed the Foreign Account Tax Compliance Act (“FATCA”) in 2010.<sup>132</sup> Under the statute, foreign financial

<sup>127</sup> *Id.*

<sup>128</sup> Richey May, *Virtual Currency FBAR Filings in 2022: Your Questions, Answered*, RICHEY MAY (Jan. 13, 2022), <https://richeymay.com/resource/articles/virtual-currency-fbar-filings-in-2022-your-questions-answered> [<https://perma.cc/6YN2-75YB>].

<sup>129</sup> Matthew D. Lee, *US Supreme Court to Settle Long-Disputed FBAR Penalty Issue*, BLOOMBERG TAX (Sept. 12, 2022, 4:45 AM), <https://news.bloombergtax.com/tax-insights-and-commentary/us-supreme-court-to-settle-long-disputed-fbar-penalty-issue> [<https://perma.cc/E23D-Z8C8>]; see *United States v. Bittner*, 19 F.4th 734 (5th Cir. 2021). Bittner, a dual citizen of Romania and United States, had a lot of investments in Romania, which he did not disclose for the FBAR purposes. *United States v. Bittner*, 469 F. Supp. 3d 709, 712–13 (E.D. Tex. 2020). He hired a CPA and filed amendments for the years 2007 to 2011. *Bittner*, 19 F.4th at 739. “In June 2017, the IRS assessed \$2.72 million in penalties against Bittner for non-willful violations of section 5314—\$10,000 for each unreported account from 2007 to 2011, specifically 61 accounts in 2007, 51 in 2008, 53 in 2009, 53 in 2010, and 54 in 2011.” *Id.* “In June 2019, the government sued to reduce these penalty assessments to judgment.” *Id.* Bittner defended his claim, stating that “his violations were due to reasonable cause and therefore could not be penalized under 31 U.S.C. § 5321(a)(5)(B)(ii), that the maximum penalty allowed for a non-willful reporting violation under 31 U.S.C. § 5321(a)(5)(B)(i) is \$10,000 per annual FBAR form, and that the penalties as assessed violated the excessive fines clause of the Eighth Amendment.” *Id.* “The court . . . granted summary judgment on Bittner’s liability for the years 2007 to 2010, rejecting his reasonable-cause defense.” *Id.* at 740 (citing *Bittner*, 469 F. Supp. 3d at 727–29). Both parties appealed; the Fifth Circuit reversed on appeal and the Supreme Court of United States granted certiorari. See *Bittner*, 19 F.4th at 749; see also *IRS Issues Maximum FBAR Non-Willful Penalty (\$3M)—U.S. vs Bittner*, GOLDING & GOLDING (Jan. 29, 2023, 10:08 PM), <https://www.goldinglawyers.com/irs-3m-multi-account-non-willful-fbar-penalty-u-s-vs-bittner/> [<https://perma.cc/9U6L-UMGY>].

<sup>130</sup> *IRS Issues Maximum FBAR Non-Willful Penalty (\$3M)—U.S. vs Bittner*, *supra* note 129.

<sup>131</sup> *Bittner v. United States*, 143 S. Ct. 713, 720 (2023).

<sup>132</sup> H.R. 2847, 111th Cong. (2010) (enacted); see Pub. L. No. 111-147, §§ 501, *et seq.*; 124 Stat. 71, 97–117 (2010).

institutions are obligated to identify and report information about U.S. account holders to the IRS.<sup>133</sup> Institutions that fail to comply with the requirements face a thirty percent withholding tax on certain types of U.S.-sourced income.<sup>134</sup> Currently, “the FATCA does not require virtual wallet providers, specialized storage services for crypto currency, to report American accounts or virtual wallets to the U.S. government.”<sup>135</sup> FATCA has failed to keep up with the evolution of this digital space, leading to tax evasion using offshore exchanges.<sup>136</sup>

However, in February 2022, the IRS announced in IR-2022-33 that it was revising the Form 14457, entitled Voluntary Disclosure Practice Preclearance Request and Application (“Voluntary Disclosure”) to add the disclosure of cryptocurrencies to the voluntary disclosure program.<sup>137</sup> The updates include “[a]n expanded section for reporting virtual currency.”<sup>138</sup> Since the inception of the program, thousands of taxpayers have used the program to come to compliance with various tax laws and avoid potential criminal liabilities.<sup>139</sup> The addition of the virtual currency sections shows the IRS’s eagerness to achieve top-notch compliance in the virtual currency domain.<sup>140</sup>

## V. ISSUES DUE TO LACK OF TAX REGULATION

The lack of tax regulation is directly associated with increasing the tax gap, leading to tax evasion and lack of compliance.

The gross “tax gap” is the difference between the total taxes owed to a state and the total taxes paid on time by its taxpayers. The net tax gap is the gross tax gap after deduction of voluntary or enforced late payment of taxes. The components that make up the gross tax gap are the underreporting of tax liabilities, unfiled tax returns and the underpayment of tax liabilities. In most countries, the

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<sup>133</sup> See I.R.C. § 1471–74.

<sup>134</sup> I.R.C. § 1471.

<sup>135</sup> Elizabeth M. Valeriane, *IRS, Will You Spare Some Change?: Defining Virtual Currency for the FATCA*, 50 VAL. UNIV. L. REV. 863, 865 (2016) (citing Alison Bennett, *IRS is Focusing Criminal Investigations on Use of Virtual Currency to Evade Taxes*, BLOOMBERG BNA (Oct. 3, 2014), <https://bloomberglaw.com/> [<https://perma.cc/7WKZ-YKF5>]).

<sup>136</sup> *Id.* at 866–67.

<sup>137</sup> I.R.S. News Release IR-2022-33 (Feb. 15, 2022) (“Form 14457 permits taxpayers who may face criminal prosecution for willful violation of tax law to voluntarily disclose information to the IRS that they failed to previously disclose.”).

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> See *id.*

underreporting of individual income tax liabilities is by far the largest component of the tax gap. In the United States, for example, the gross tax gap has been steady over the past 30 years at around 15 to 18% of the total tax liability, with underreported individual income tax liabilities representing about 70% of the gap and about 10% being attributable to corporate income tax.<sup>141</sup>

In addition to increasing the tax gap, the anonymity of the virtual currency is often linked with various criminal activities such as money laundering, financing terrorism and other illegal activities on the dark web, fraud, human trafficking, etc.<sup>142</sup>

Another issue that crops up with the inconsistent regulatory framework is the correct classification of various virtual assets, currencies, and transactions.<sup>143</sup>

In 2018 . . . [a] court held for the first time that all virtual currencies were commodities and thus subject to [Commodities Futures Trading Commission] jurisdiction . . . . The court reasoned that “[v]irtual currencies are ‘goods’ exchanged in a market for a uniform quality and value’ and thus fall within the common definition of commodity under U.S.C. § 1(a)(9).

. . . .

Recent statements by [former Securities and Exchange Commission (“SEC”)] Chairman Jay Clayton indicate that the SEC has differentiated between crypto assets that are used “as securities to raise capital for a venture,” which would fall under the SEC’s purview as a security, while Bitcoin was more of a “payment mechanism and store of value” as opposed to a security.<sup>144</sup>

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<sup>141</sup> Tatiana Falcao & Bob Michel, *Taxation of Cryptocurrencies*, in 5 Inter-Am. Ctr. Tax Admins., *Manual for the Control of International Tax Planning: Tools for Combating International Tax Planning* 21 (2022).

<sup>142</sup> *Id.* at 20.

<sup>143</sup> See Bakradze, *supra* note 111, at 347, 352–53.

<sup>144</sup> *Id.* at 349–51.

## VI. PROPOSALS

The current regulations and “reporting requirements are not only outdated but they fail to keep pace” with the rate at which virtual transactions are evolving.<sup>145</sup> The IRS Notice 2014-21 defines the virtual currency too broadly and its information reporting requirements are too vague.<sup>146</sup> To address the noncompliance, the IRS has to deal with increased administrative costs which become unduly burdensome to both the agency and the taxpayers.<sup>147</sup> Thus, the agency should take steps in mitigating these costs and noncompliance by adopting “the GAO’s proposed classification of [the] virtual currency systems.”<sup>148</sup>

The IRS has previously maintained the position that FAQs may not be relied upon as legal authority.<sup>149</sup> The agency has changed its position recently, but the taxpayer should be careful when relying on an FAQ.<sup>150</sup> A taxpayer who relies on informal guidance to his or her detriment is left with reasonable cause as the only defense to penalties.<sup>151</sup> If a taxpayer is relying on an FAQ, they should take a print-out of the FAQ and keep it filed until the statute of limitations has expired.<sup>152</sup>

There should be easy-to-navigate forms used by the third-party intermediaries. For example, when intermediaries do issue forms, the 1099-Crypto (Composite) form, or a 1099-K form, both used by Robinhood, the forms are complicated to navigate.<sup>153</sup> The IRS should provide clear and uniform reporting requirements for third-party intermediaries.<sup>154</sup> The Infrastructure Investment and Jobs Act (H.R. 3684) provided some provisions that updated the definitions of who

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<sup>145</sup> Aaron Hsieh, *The Faceless Coin: Achieving a Modern Tax Policy in the Changing Landscape of Cryptocurrency*, 2019 UNIV. ILL. L. REV. 1079, 1110–11 (2019).

<sup>146</sup> *Id.* at 1103, 1107, 1111 (citing Notice 2014–21, 2014-16 I.R.B. 938).

<sup>147</sup> *Id.* at 1102–03, 1108.

<sup>148</sup> *Id.* at 1115 (citing Nika Antonikova, *Real Taxes on Virtual Currencies: What Does the I.R.S. Say?*, 34 VA. TAX REV. 433, 451 (2015)).

<sup>149</sup> See Monte A. Jackel, *The Proper Role of FAQs*, PROCEDURALLY TAXING (May 8, 2020), <https://procedurallytaxing.com/the-proper-role-of-faqs/> [<https://perma.cc/RU3R-9GDJ>].

<sup>150</sup> See *id.*

<sup>151</sup> See *id.*

<sup>152</sup> See Nellen, *supra* note 16.

<sup>153</sup> See *Everything You Need to Know About Robinhood Tax Documents & Tax Reporting*, ZENLEDGER (Mar. 24, 2022), <https://www.zenledger.io/blog/robinhood-tax-documents-tax-reporting> [<https://perma.cc/7HGY-XKDP>].

<sup>154</sup> In order to reduce some challenges related to illicit crypto transfers and tax evasion, the IRS should enhance reporting requirements by issuing nuanced regulations on participating intermediaries, such as crypto exchanges. See Avi-Yonah & Salaimi, *supra* note 1, at 10 n.51.

qualifies as a “broker” for cryptocurrency purposes.<sup>155</sup> The definition of a broker is expanded to include “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.”<sup>156</sup> “Any entity qualifying as a broker is required to furnish a return showing any transfers during a calendar year which occurred in an account maintained by the broker.”<sup>157</sup> This is a step forward for regulating cryptocurrency compliance; however, the definition of who qualifies as a “broker” is still very broad.<sup>158</sup>

While the FAQs talk about hard forks, air drops, payments in virtual currency in exchange for services, etc., no guidance is provided about how the IRS classifies staking tokens or rewards.<sup>159</sup> It is a gray area and taxpayers need more guidance regarding what staking rewards are: are they income in exchange of services or interest dividends? Another issue that the *Jarrett* case raised is that courts are not the right place to decide matters such as tax law and tax treatment of virtual currency.<sup>160</sup> Treasury and Congress should decide these technical issues and set a precedent. A coherent scheme is necessary as entirely new income categories may need to be created in order to tax cryptocurrency properly.<sup>161</sup>

The growing fad for NFTs, along with no guidance from the IRS, has made it crucial for the taxpayers to keep track of their NFT transactions. The IRS has to provide some guidance on the tax treatment of the NFTs. The IRS should add some FAQs addressing the tax treatment of NFTs as NFTs are already a multi-billion-dollar industry. “Although Notice 2014-21 is relevant to NFTs purchased with virtual currency, it does not directly address the tax consequences of NFTs.”<sup>162</sup>

Because of the steep sanctions and penalties under the FBAR, guidance on virtual assets held overseas should be updated and comprehensive. “On May 30, 2018, the AICPA (American Institute

<sup>155</sup> Marie Sapirie, *Implementing the New Crypto Reporting Guidance*, 173 TAXNOTES FED. 1058, 1058 (2021).

<sup>156</sup> I.R.C. § 6045(c)(1)(D) (2021).

<sup>157</sup> See Steven Williams, *Tax It “To the Moon”: A Cryptocurrency Story*, SETON HALL UNIV. STUDENT SCHOLARSHIP 1, 17 (2022), [https://scholarship.shu.edu/student\\_scholarship/1292](https://scholarship.shu.edu/student_scholarship/1292) [<https://perma.cc/SGS7-NRNC>].

<sup>158</sup> See *id.* at 21.

<sup>159</sup> See *Frequently Asked Questions on Virtual Currency Transactions*, *supra* note 10.

<sup>160</sup> See Parsons, *supra* note 81, at 2–3 (“The federal courts are not the right institution to address this crisis”).

<sup>161</sup> See *id.* at 18–19.

<sup>162</sup> Lisa M. Blum & Benjamin P. Foster, *The Taxation of Nonfungible Token Transactions*, CPA J. (Aug. 13, 2021), <https://www.cpajournal.com/2021/08/13/the-taxation-of-nonfungible-token-transactions/> [<https://perma.cc/LT9J-BKLE>].

of Certified Public Accountants) wrote a letter to the IRS to obtain further definition and clarity regarding Virtual Currency . . . FATCA and FBAR reporting requirements.”<sup>163</sup> The IRS responded that the taxpayers are required to report the virtual currencies held in a jurisdiction other than the United States under the FBAR or FATCA if their respective reporting thresholds are met.<sup>164</sup> The IRS must require the reporting by virtual wallet providers offshore by updating their “intergovernmental agreements.”<sup>165</sup>

The IRS should provide clear guidance on the reporting of virtual currency held as a foreign asset and should also provide links to other relevant notices, publications, and revenue rulings. In addition, it should incorporate the suggested FAQs and their responses mentioned in the AICPA letter on its website under the FAQs on virtual currency.

It has been almost a decade since there has been any real guidance on the virtual currency despite its growth. The IRS Tax Notice 2014-21 acknowledged that there were many unanswered questions pertaining to the taxation of virtual currency.<sup>166</sup> The current guidance on virtual currency and its related transactions provides little clarity about the basic tax treatment of such transactions.<sup>167</sup> However, the taxpayers need more comprehensive guidance that is updated regularly.

The new IRS enforcement strategy for virtual currency transactions is likely to go into effect from 2024.<sup>168</sup>

On July 27 the IRS released a draft version of Form 1040, “U.S. Individual Income Tax Return,” for tax year 2022, which

<sup>163</sup> Stanley Foodman, *Taxpayers That Have Virtual Currency Held in a Centralized Virtual Currency Exchange Outside the U.S Must File an FBAR and FORM 8938!*, JD SUPRA (June 10, 2019), <https://www.jdsupra.com/legalnews/taxpayers-that-have-virtual-currency-77752/> [<https://perma.cc/BN3V-WRZA>]. The letter was in the format of FAQs and the IRS responded in the same format. *Id.*; see also Letter from Annette Nellen, Chair, AICPA Tax Exec. Comm., to Internal Revenue Serv. (May 30, 2018), <https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180530-aicpa-comment-letter-on-notice-2014-21-virtual-currency.pdf> [<https://perma.cc/6K3W-UY8T>].

<sup>164</sup> Foodman, *supra* note 163.

<sup>165</sup> Valeriane, *supra* note 135, at 895 (citing Rajiv Prasad, *FBAR and FATCA Compliance in the Age of Digital Currencies*, TAX ADVISER (May 1, 2014), <https://www.thetaxadviser.com/issues/2014/may/clinic-story-07.html> [<https://perma.cc/E9QU-YDVT>]); see also Valeriane, *supra* note 135, at 894 n.157 (referring to Prasad’s article as “agreeing that virtual exchanges could be subject to the FATCA obligations”).

<sup>166</sup> See Notice 2014-21, 2014-1 I.R.B. 938.

<sup>167</sup> See Stevie D. Conlon, Anna Vayser & Robert Schwaba, *IRS Releases New Cryptocurrency Tax Guidance*, 21 J. TAX PRAC. & PROC. 19, 21 (2019).

<sup>168</sup> Mary Katherine Browne, *IRS to Expand Digital Asset Reporting on Form 1040*, 176 TAX NOTES FED. 1019, 1019 (2022).

changed the wording of its question concerning cryptocurrency to read: “At any time during 2022, did you (a) receive (as a reward, award, or compensation); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?”<sup>169</sup>

The draft language is considerably broader and would require the taxpayers to declare any and all of their virtual asset activity. The change in the draft language from “virtual currency” to “digital asset” shows that the IRS is trying to encompass fungible and non-fungible digital assets for reporting requirements.<sup>170</sup>

Since the IRS is increasing its enforcement actions against taxpayers who try to hide virtual currency, the need for additional guidance is obvious.<sup>171</sup> Taxpayers dealing in virtual currency need to be extra vigilant while filing their federal and state tax returns to properly document their transactions, as the reporting requirements can be complicated.<sup>172</sup>

Treasury and Congress need to step in and work collaboratively to develop a “coordinated and coherent tax scheme” for virtual currency and its related transactions.<sup>173</sup> With the growing popularity of the virtual currency market (whether it’s staking or NFTs); its eruptive volatility;<sup>174</sup> billions and billions of dollars at stake; and to avoid litigation, Treasury and Congress need to act promptly and be responsive.<sup>175</sup>

A positive development is President Biden’s Executive Order, dated March 9, 2022, on Ensuring Responsible Development of Digital Assets, which entails a holistic approach to development and

<sup>169</sup> *Id.*

<sup>170</sup> *See id.*

<sup>171</sup> *See Moore, supra* note 50.

<sup>172</sup> Kramer, *supra* note 9, at 61.

<sup>173</sup> *See Parsons, supra* note 81, at 18.

<sup>174</sup> “TerraUSD, or UST, has been dragged into the spotlight . . . after the so-called stablecoin [“Luna”] which is supposed to be pegged one-to-one with the U.S. dollar, fell sharply below the \$1 mark.” Arjun Karpal, *Cryptocurrency Luna Now Almost Worthless After Controversial Stablecoin It Is Linked to Loses Peg*, CNBC CRYPTO WORLD (May 12, 2022), <https://www.cnbc.com/2022/05/12/cryptocurrency-luna-now-almost-worthless-after-ust-falls-below-peg.html> [<https://perma.cc/2MSE-P4J8>]. “Luna’s price has plunged from around \$85 . . . to trade at around 4 cents . . . , making the cryptocurrency almost worthless.” *Id.* The U.S. Treasury Secretary Janet Yellen recently stated that “there are risks to financial stability, and we need a framework that’s appropriate,” later suggesting that legislation should work on regulating crypto. Jesse Hamilton, *UST Woes Draw Spotlight in Janet Yellen’s Senate Hearing on Financial Risks*, COINDESK (May 10, 2022), <https://www.coindesk.com/policy/2022/05/10/ust-woes-draw-spotlight-in-janet-yellens-senate-hearing-on-financial-risks> [<https://perma.cc/FXG7-XR24>].

<sup>175</sup> *See Parsons, supra* note 81, at 19–20.

regulation of the Digital Assets and the transactions thereof.<sup>176</sup> The order highlights the need for multiple regulating organizations such as the SEC and the Commodity Futures Trading Commission to work collaboratively to investigate and combat the illegal activities in the virtual domain.<sup>177</sup> The report encourages the Treasury to share information with other financial regulatory bodies to bolster their capacity to mitigate risks in the cyber space.<sup>178</sup>

The Organization for Economic Co-operation and Development (“OECD”)<sup>179</sup> published the Crypto-Asset Reporting Framework and Amendments to the Common Reporting Standard (“CARF”) in March 2022.<sup>180</sup> According to the OECD, “individuals [who] hold Crypto-Assets unaffiliated with any service provider and transfer such Crypto-Assets across jurisdictions, pose a risk that Crypto-Assets will be used for illicit activities or to evade tax obligations.”<sup>181</sup>

As OECD seeks to expand its reporting requirements relating to various cryptocurrency transactions, “President Biden has proposed expanding on the current FATCA reporting requirements for financial institutions and digital asset brokers to facilitate the automatic exchange of information under tax treaties.”<sup>182</sup>

Given the domestic and international efforts to provide more competent guidelines for cryptocurrency regulation, more guidance is expected. In light of the recent FTX scandal, it is likely that next year Congress will act to regulate crypto.<sup>183</sup>

<sup>176</sup> Exec. Order No. 14067, 87 Fed. Reg. 40881 (Mar. 9, 2022).

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> OECD BETTER POLICIES FOR BETTER LIVES, [https://www.oecd.org/about/\[https://perma.cc/V67Z-TPUD\]](https://www.oecd.org/about/[https://perma.cc/V67Z-TPUD]).

<sup>180</sup> Christopher Ignatius Moylan, OECD’s Proposed Crypto-Asset Reporting Framework (CARF): A Critique, 21–22 (2022) (LL.M. thesis, Uppsala University).

<sup>181</sup> *Crypto-Asset Reporting Framework and Amendments to the Common Reporting Standard*, 2022 OECD 1, 4.

<sup>182</sup> Nick Sutter & Lisa M. Zarlenga, *OECD Releases Cryptocurrency Tax Reporting Framework Proposal for Public Comment*, STEPTOE (April 2022), <https://www.stepto.com/en/news-publications/oecd-releases-cryptocurrency-tax-reporting-framework-proposal-for-public-comment.html> [https://perma.cc/JX86-WFRF]. “Zarlenga said ‘The CARF parallels in many respects the expanded broker reporting and cash reporting in the Infrastructure Investment and Jobs Act. But those rules only apply to US customers. With respect to foreign customers, the US collects less information than other countries do via CRS.’ ‘The Greenbook proposal would more closely align US law with CRS,’ [Zarlenga] added, ‘but it will be interesting to see if the US goes further and adopts something similar to the CARF.’” *Id.*

<sup>183</sup> Luke Hogg, *FTX Fiasco Means Coming Consequences for Crypto in Washington DC*, COINTELEGRAPH (Nov. 20, 2022), <https://cointelegraph.com/news/ftx-fiasco-means-consequences-for-crypto-out-of-washington-dc> [https://perma.cc/7V8Z-ELYG]. Amidst the collapse of FTX failing the acquisition by Binance, FTX and around 130 of its affiliated companies filed for Chapter 11 bankruptcy. *Id.* Court filings indicate that there could be around one million creditors for the FTX group. *Id.*



[T]here are two major bills that seek to provide clarity for the crypto industry. The Lummis-Gillibrand Responsible Financial Innovation Act delineates the jurisdiction over digital assets between the Securities and Exchange Commission (SEC) and Commodities and Futures Trading Commission (CFTC), allow exchanges to register with the CFTC, and create new requirements for stablecoin providers, among other things. The Digital Commodities Consumer Protection Act (DCCPA) would grant the CFTC exclusive jurisdiction over digital commodity trades, mandate that exchanges register with the CFTC and create new disclosure requirements for digital commodity brokers, among other things.<sup>184</sup>

Experts opine that Congress is unlikely to vote on these bills this year.<sup>185</sup> In light of the latest scandal involving FTX, it is definitely time to revisit the proposals next year once Congress is in session.<sup>186</sup>

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<sup>184</sup> *Id.*

<sup>185</sup> *See id.*

<sup>186</sup> *See id.*