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De Minimis Exception Could Hinder Crypto Tax Administration

By **Amy Lee Rosen**

Law360 (November 19, 2019, 2:22 PM EST) -- While providing an exemption from taxation and reporting requirements for small-value cryptocurrency transactions could help simplify disclosures for holders, it might thwart IRS compliance efforts by encouraging cryptocurrency holders to game the system while increasing administrative burdens.

A bitcoin ATM at a Sheetz convenience store in Pittsburgh. The AICPA professional group has argued for a de minimus exception to reporting cryptocurrency transactions, to ease the burden on holders. (AP)

Last month the Internal Revenue Service published long-awaited guidance on the tax treatment of cryptocurrency that explained how to calculate gains and losses and the appropriate tax basis when reporting cryptocurrency transactions for tax purposes.

The guidance did not deviate from the government's stance in a 2014 notice requiring any gain or loss from the sale or exchange of cryptocurrency to be reported the same way as any other gain or loss on the sale or exchange of property. Nor did it provide a de minimis exception that would relieve cryptocurrency holders from reporting and paying taxes on gains from small-dollar-value transactions, as advocated by the American Institute of Certified Public Accountants and others.

Though many have advocated for a de minimis exception, such a rule might invite gamesmanship that would only require more tracking and monitoring of cryptocurrency transactions by the IRS, according to Omri Marian, a professor and director of the graduate tax program at the University of California, Irvine School of Law.

“It will open a host of tax evasion and avoidance techniques aiming to avoid the de minimis threshold,” Marian said.

For example, it would be easy to imagine a world in which an army of digital robots could be programmed to separate cryptocurrency transactions to fall under the de minimis threshold to avoid triggering the tax and tax reporting requirements, Marian said. Setting up a wallet — which is a device or program that stores the public and private keys that can track, buy and sell cryptocurrency — incurs no costs, so it would not be difficult to create an app that divides one transaction into multiple wallets that could each generate gains below the de minimis threshold, whatever it would be, he said.

It would be a nightmare for the IRS to try to enforce something like that, Marian said.

In 2016 and in 2018, the AICPA told the IRS that individuals should be able to use a de minimis rule similar to that under Section 988(e)(2) of the Internal Revenue Code, which provides an exclusion up to $200 per transaction for foreign currency exchange gains. A de minimis exception that is similar to Section 988 is appropriate because when cryptocurrency holders make small purchases, tracking the basis and fair market value of the cryptocurrency for tax purposes is time-consuming and burdensome, the AICPA said.

However, Marian said, the logic for having a de minimis exception for foreign currency should not apply to cryptocurrency transactions. While foreign currency transactions are relatively infrequent, cryptocurrency transactions are not, he said. In addition, it makes no sense to bestow a tax benefit on cryptocurrency because there is no reason for the government to encourage use of cryptocurrencies instead of a country's own coin, Marian said.

Because a de minimis exception on a per-transaction basis does not make sense, the only possible way to make such a regime workable would be to aggregate transactions, such that a cryptocurrency user must report and pay taxes once a certain threshold is passed, he said.

An aggregation provision is contained in a bill introduced in the U.S. House of Representatives in April by Rep. Warren Davidson, R-Ohio, called the Token Taxonomy Act, which would exclude from gross income the gain from the sale or exchange of cryptocurrency for assets other than cash when the transaction is valued at less than $600. The bill, H.R. 2144, has an aggregation provision such that all sales or exchanges that are part of the same transaction or a series of related transactions would be treated as one sale or exchange that is subject to the $600 threshold.

However, imposing either a $200 or a $600 de minimis exception would be not only arduous to the taxpayer, but also laborious for the IRS, according to James N. Mastracchio, a tax partner at Eversheds Sutherland LLP. The government, he said, would then have to sift through tax returns to determine which de minimis claims might need to be audited, which becomes even more complicated with an aggregation provision.

“On the tax administration side, the more rules you put in place, the more burden there is, both on taxpayer and the IRS,” Mastracchio said. “The taxpayer would have to establish whether they qualify for the de minimis [exception], and the IRS would have to check whether the taxpayer was correct. Then, if you aggregate the amount, which would then preclude a de minimis exception, again you're adding a new rule with new counting and reporting.”

Making the taxpayer simply report and pay appropriate taxes on all cryptocurrency transactions would be much easier because neither the holder nor the IRS would have to figure out the de minimis transactions and then determine aggregate amounts, he said.

Whenever a tax exception is created, it will almost always open up the door for potential abuse, because people will always try to find loopholes so they do not have to report and pay taxes on income, according to S. Starling Marshall, a partner in Crowell & Moring LLP's tax and litigation groups.

“I'm hesitant to create a road map for people to potentially break the law, [but] you could imagine a scenario where somebody has some program that continuously makes exchanges just under the amount, many times a day, or once a day,” she said. “Whatever the rule ends up being, [an abusive practice] would keep it under the reporting exceptions, where they're amassing gains so that each one doesn't go up over the de minimis exception.”

But the potential for bad actors to abuse the system is not reason enough to avoid a de minimis exception, Marshall said. If the IRS is worried about abuse, it could impose a yearly cap or daily cap on transactions, establish anti-abuse rules or even impose higher penalties to discourage this type of gaming, Marshall said.

In fact, having a $600 de minimis exception as proposed by the Token Taxonomy Act might actually assist the IRS, because the agency would not be inundated with the potentially useless information that would come from receiving reports on smaller transactions, according to Kevin Johnson, a partner who practices tax controversy and litigation at BakerHostetler.

Tax administration includes not only tax enforcement but also everything else the IRS does, such as processing returns, collecting information, investigating crimes and initiating collections proceedings, Johnson said. If small-value transactions are being reported, he said, then the agency will have to process all those returns, which at some point creates a heavier administrative burden.

While there is always the potential for abuse if a de minimis threshold is imposed, the IRS could create an anti-structuring rule such as the one that applies to bank deposit reporting requirements, in order to prevent cryptocurrency users from breaking up larger transactions into smaller ones to avoid tax reporting obligations, he said.

“The government will have [to create] a rule that says if you intentionally structure transactions to avoid exceeding the de minimis exception, that's a violation,” he said.

However, Marian said the problem with an aggregation provision, anti-abuse rules and other safeguards like penalties or structuring is the practical question of how this new reporting regime would be monitored and enforced, because anonymous or semianonymous cryptocurrency holders can theoretically hide behind a wallet to game the system at low cost.

“The cost in trying to find these people, because it's anonymous or semianonymous, is extremely high, and this would create a real challenge for tax enforcement,” he said.

--Editing by Robert Rudinger and John Oudens.