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Cryptocurrency Transfers and Data Collection

Overview

The extent to which the government should collect data on and require reporting of cryptocurrency (“crypto”) transfers has been the focus of recent policy discussions. Both the Biden Administration’s FY2022 budget proposal and H.R. 3684, as amended and passed by the Senate on August 10, 2021, would enhance and expand tax information reporting for certain crypto transfers.

Requiring more data collection on crypto transfers presents policymakers with a potential trade-off. On the one hand, enhanced data collection and reporting could lead to increased tax revenue and lower levels of illicit financial activity. On the other hand, enhanced data collection could lead some crypto market participants to move their operations offshore to avoid government oversight, which may negatively impact a burgeoning sector of the U.S. economy.

This In Focus summarizes current data reporting requirements for certain crypto transfers, reviews recent policy proposals, and presents selected policy considerations.

Cryptocurrency Transfer Practices

Crypto transactions are typically carried out over a crypto exchange, which is a type of financial institution that facilitates the trading, buying, and selling of various crypto assets such as Bitcoin, Ethereum, and Litecoin. Several crypto exchanges, such as Binance and Coinbase, are licensed and regulated at the state level as money transmitters, a type of financial company classification that includes other firms such as Western Union, MoneyGram, and PayPal. Some banking institutions known as custody banks also provide crypto transfer services. (In addition, if exchanges transact digital asset securities, they are subject to securities law, which is outside of the scope of this In Focus.)

Money transmitters generally carry out three business functions: (1) receiving and sending money on behalf of consumers; (2) providing products that receive, store, or send money for customers; and (3) exchanging currencies. Unlike banks, money transmitters do not accept deposits or make loans but instead provide alternative mechanisms for people to transfer money.

Current Data Collection

Current federal data collection efforts on crypto transfers stem from two sources: the need for additional data so the Internal Revenue Service (IRS) can administer existing federal tax law and anti-money laundering (AML) policies that implement provisions of the Bank Secrecy Act (BSA; P.L. 91-508)—the primary U.S. AML law.

Internal Revenue Service

The IRS collects data on crypto transactions in its role as the administrator of the Internal Revenue Code. The IRS has clarified, via Notice 2014-21 and an FAQ on virtual currency transactions, that taxpayers are required for tax purposes to treat crypto transactions in the same manner as transactions involving other mediums of value (e.g., cash, checks, stocks). For example, crypto transactions are subject to the tax code’s capital gains and losses rules. Similarly, federal income and employment tax rules apply when crypto is used by a business to compensate an individual for service provided.

Crypto transactions are also generally subject to the same information reporting requirements as non-crypto transactions. One exception appears to be the federal law requiring businesses to report transactions exceeding \$10,000 in cash to the IRS using Form 8300. IRS Commissioner Charles Rettig stated at a June 8, 2021, Senate Committee on Finance hearing that he believes congressional authority is needed to apply the cash transaction reporting requirements to crypto currency.

In general, the data collected by the IRS primarily come from voluntary reporting on annual tax returns and third-party information returns, as well as from summons and audits. IRS data, however, are far from complete, especially with respect to cryptocurrency. This reflects the intent of most cryptocurrencies “to stay off the radar screen,” as Rettig stated at the hearing referenced previously. Incomplete voluntary reporting of crypto transactions contributes to the tax gap, or the difference between the aggregate amount of taxes legally owed and the aggregate amount of taxes collected.

Financial Crimes Enforcement Network

The federal agency responsible for implementing regulations for money transmitters and provisions of the BSA is the U.S. Treasury’s Financial Crimes Enforcement Network (FinCEN). In 2013, FinCEN issued interpretative guidance for virtual currency exchanges, stating that an “administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN’s regulation.” This guidance effectively brings crypto exchanges under the same reporting regime as other money transmitters.

Money transmitters are required to register with FinCEN within 180 days of being established, and these registrations are supposed to be renewed every two years. Money transmitters must maintain financial records and conduct customer identification procedures for certain transactions,

and they must obtain and verify customer identity and record information for transfers of more than \$3,000.

In addition, money transmitters must file currency transaction reports for transactions of \$10,000 or more in a day. They must also file suspicious activities reports (SARs) for dubious transactions of generally more than \$2,000, which the remittance provider “knows, suspects, or has reason to suspect involves funds from illegal activity or is designed to conceal their origin, is designed to evade BSA obligations, or has no apparent business or law purpose.” Money transmitters are prohibited from disclosing to an individual involved with a transaction that a SAR has been filed. Further, the money transmitter and its employees are shielded from civil liability for any SAR filed.

Selected Policy Proposals

The President’s FY2022 budget proposes requiring crypto exchanges and custodians to file information returns with the IRS that report the amount flowing into and out of customer accounts with gross flows above \$600. The Administration’s proposal includes a separate reporting requirement for inter-broker crypto transfers and would require businesses that accept crypto to report crypto transactions exceeding \$10,000 in value to the IRS.

The Administration also proposes expanding the information reporting requirements for brokers, including crypto exchanges and wallet providers, to include information on U.S. and certain foreign account owners. The Administration states this would allow for automatic information sharing with foreign tax jurisdictions in exchange for information on U.S. taxpayers transacting in crypto outside the United States.

H.R. 3684, as passed by the Senate on August 10, 2021, would require a party facilitating the transfer of crypto to file an information return as a broker with the IRS. The Senate-passed version of H.R. 3684 would also require a business that receives crypto worth more than \$10,000 in a single transaction to report the transaction to the IRS. The Joint Committee on Taxation (JCT) estimates that these information reporting requirements would raise \$28 billion over 10 years.

Selected Policy Considerations

Reporting requirements raise a number of general policy questions. One is the question of who should be responsible for the reporting. For example, brokers of transactions are responsible for reporting transaction data; however, crypto participants follow a range of business models that do not conceptually align with the current financial regulatory or tax code definitions of *broker*. This is evidenced by the rise of decentralized financial institutions, which allow peer-to-peer transactions to occur without formal brokers.

To that end, some industry stakeholders and policymakers have expressed concern that the language regarding brokers in the Senate-passed version of H.R. 3684 is too broad and could subject parties that would otherwise not be considered brokers or middlemen (e.g., crypto software developers, miners, blockchain validators) to reporting

requirements, which they cannot satisfy due to the pseudonymous nature of crypto.

Another question concerns the appropriate balance between government data collection and the rights of individuals. Data collection and reporting may assist the IRS and FinCEN in fulfilling their statutory obligations, but it also subjects individuals and businesses to greater government scrutiny and places an administrative burden on those required to make reports. However, a certain amount of required reporting may enable individuals to more easily comply with the law. For example, brokers are currently required to send individual investors a copy of any Form 1099-B filed with the IRS. Form 1099-B contains important information taxpayers need to pay the appropriate tax on transactions involving stock, bond, and other financial securities.

Tax Gap

The JCT’s estimates of H.R. 3684 suggest that requiring information returns on crypto transactions would reduce the tax gap. The latest IRS estimates suggest that the gross tax gap costs the federal government \$441 billion in lost tax revenue per year. Late payments and enforcement actions reduce this gap to \$381 billion. One of the main drivers of the tax gap—whether from honest mistakes or purposeful tax evasion—is understating tax liability. Income tax liability is understated as a result of taxpayers underreporting their income and/or claiming more in tax benefits than they are eligible for.

The latest IRS tax gap estimates generally do not reflect the impact crypto is having on tax collections, as that market was rather small during the period examined (2011-2013). In an April 13, 2021, Senate Committee on Finance hearing Commission Rettig raised the possibility that the tax gap may now be closer to \$1 trillion per year once the rise in popularity of crypto, foreign source income, taxable illegal income, and more recent estimates regarding high-income taxpayers are accounted for. Some have questioned the accuracy of this estimate. Although enhanced reporting requirements may help to close the tax gap, some underreporting of income generated from crypto transactions will likely still continue as some crypto transactions are intended to elude authorities.

Illicit Financial Activity

FinCEN’s data reporting regulations implement AML laws. The extent to which applying them to crypto can effectively limit illicit financial activity, without stifling a potentially beneficial financial tool, is an open question. Crypto can be used across jurisdictions with relative ease, and many crypto users value its relative cash-like anonymity compared to traditional electronic money transfers. Thus, enhancing reporting requirements on crypto transactions may incentivize crypto customers to transact outside of the United States. In addition, to the extent reporting obligations are perceived as creating a “paper trail,” some legitimate consumers who would otherwise use crypto may avoid it. Policymakers face a tradeoff in this industry between providing the necessary tools to ensure AML compliance and driving activities out of the U.S. market.

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