

Fact Sheet: Cryptocurrency Tax Evasion and National Security Threats

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The Many Dangers of Creating Explicit Tax Carveouts for Cryptocurrency

Cryptocurrency is a [\\$2 trillion market](#), with an increasing institutional presence, from [crypto hedge funds](#) to [large banks](#). There are many different players across the space, including exchanges that trade crypto, wallets that store it, and “miners” that add new transactions to cryptocurrency blockchains.

Reporting indicates that taxable cryptocurrency income is [vastly underreported](#). This has created a market for services like [Koinly](#) or [CoinTracker](#), which charge up to [several hundred dollars](#) to generate tax forms for individual investors by importing their crypto transactions from multiple crypto websites. But the burden of cryptocurrency tax reporting should not fall only on the individual investor; service providers across the cryptocurrency space should also be furnishing tax reports to the IRS about the taxable gains of its users.

Should policymakers fail to give the Treasury Department the proper tools to ensure tax compliance across all crypto market actors, it risks creating a two-tiered system: one that furnishes tax reporting, and one that operates without tax reporting obligations. This could create easily accessible pathways for bad actors to avoid reporting — and a race to the bottom. Policymakers should not sacrifice reasonable regulations in order to create carveouts that give carte blanche to evade taxes.

The cryptocurrency industry has promoted many myths about why its technology isn’t set up to enable tax reporting. In reality, these are not technological limitations but rather design decisions. One of the major marketing points made by so-called “decentralized exchanges” is the lack of “Know Your Customer” (KYC). Read below for further background on why exempting portions of the cryptocurrency marketplace from tax reporting would create significant regulatory, tax, and national security gaps.

Cryptocurrency Mining Pools Should Be Held Accountable for Tax Reporting

Cryptocurrency miners add new transactions to cryptocurrency blockchains. In exchange, they earn fees in crypto (for example, if they are miners on the Bitcoin blockchain, they earn fees in Bitcoin; miners on the Ethereum

blockchain earn Ether). Cryptocurrency mining is a sophisticated marketplace with many large firms and “mining pools.” Some academics have argued that miners [may be money transmitters](#).

While some in the cryptocurrency lobbying space have argued miners can be “[a kid in their dorm room](#),” they are generally not acting alone because it’s not profitable to do so without extensive and expensive hardware rigs. To address this, individual miners typically join mining pools that provide software for users to install to their computers and split cryptocurrency earnings among its user base.

Cryptocurrency mining pools generate massive revenues for their users. One mining pool, [Slush Pool](#), has collectively mined more than [1.2 million Bitcoin](#) since December 2010 (which would be worth about \$47.5 billion at today’s Bitcoin prices).

Additionally, there are now publicly traded companies devoted to cryptocurrency mining, like [Riot Blockchain](#). Riot Blockchain owns the Texas-based [Whinstone Inc](#), the largest North American miner. China recently cracked down on crypto mining, leading to an exodus of larger mining companies from the country. As a result, Chinese mining firms [BIT Mining](#) and Bitmain are both [expanding their presence](#) in Texas.

In order to manage their risk, larger cryptocurrency mining firms work with private crypto investment funds like BitOoda. [BitOoda](#) offers financial derivatives to help miners hedge risk with products like the “Bitcoin Hashpower Contract” and “BitOoda Difficulty Swap.”

From over decade-old mining pools to publicly traded mining companies that employ financial derivatives to hedge risks, the cryptocurrency mining industry is made up of sophisticated technical players capable of furnishing tax reports to the IRS about the users in their mining pools.

Cryptocurrency Wallet Tax Reporting Is Crucial for Stopping Tax Evasion

Crypto wallets allow a user to hold crypto outside of a crypto exchange. They store the “private keys” a user needs to buy or sell crypto. Some wallets are software (browser extensions or iPhone/Android apps), and some are hardware (like the “[Ledger](#)” wallet). Some crypto wallets charge and collect fees from users by supporting trading crypto from within the wallet itself, as [the MetaMask wallet](#) supports.

International regulators have voiced concerns around anonymous cryptocurrency wallets in particular, for their potential to facilitate money laundering or terrorist financing. Attempts to carve cryptocurrency wallets out of tax compliance could impact several existing regulatory proposals, including:

- A [FinCEN proposal](#) to bring more oversight to “unhosted” crypto wallets;
 - Unhosted wallets have no connection to a bank or other regulated entity that would be responsible for applicable compliance.
 - Unhosted wallets currently have no regulated touchpoint for transaction monitoring or due diligence screening.
- The European Commission’s [proposal to prohibit anonymous crypto wallets](#) in order to address money laundering and terrorist financing concerns; and
- [Draft guidance](#) by the Financial Action Task Force (the global money laundering and terrorist financing watchdog) defining Virtual Asset Service Providers that are subject to anti-money laundering and terrorist financing regulations.

The cryptocurrency lobby has argued that wallet providers deserve carveouts, in part, because they help protect crypto assets from theft. But these wallet providers in some cases have failed to protect their customers. In

December 2020, the names, mailing addresses, and phone numbers for [272,000 customers](#) of the hardware wallet company Ledger were released online by hackers. In 2021, Ledger customers began receiving in the mail what appeared to be replacement wallets, but were actually [counterfeit wallets](#) aimed at stealing their crypto.

If cryptocurrency wallets receive a blanket exemption from tax reporting requirements, it will make tax evasion much easier. The market overall may move out of exchanges required to comply and onto wallets that interact with “decentralized exchanges,” potentially rendering any transactions in them invisible to the IRS, to FinCEN, and to other agencies.

Decentralized Exchanges and Cryptocurrency Platforms Can —and Should— Furnish Tax Reports

Decentralized Finance (“DeFi”) is a crypto term for exchanges that let a user trade or lend crypto without any Know Your Customer (KYC) — often referred to as, “without intermediaries.” Examples are sites like [Uniswap](#) and [SushiSwap](#). The market is also growing rapidly — its market cap [exceeded \\$140 billion](#) as of May 2021.

Crypto lobbyists have tried to argue DeFi may be “[unable to satisfy](#)” tax reporting requirements. But there are at least two DeFi platforms that already offer KYC and thus could supply tax forms: [Swarm Markets](#) (based in Germany and [licensed with BaFin](#)) and Aave, a crypto lending platform reportedly [launching a KYC-enabled DeFi platform for institutions](#).

The lack of KYC on the rest of DeFi is a *design choice*, not a technological limitation. Here are a series of articles trumpeting DeFi sites without KYC:

- Hacker Noon, “[5 Great Crypto Exchange Platforms that Don’t Require KYC Verification](#)”
- Bitcoin.com, “[6 Cryptocurrency Exchanges That Don’t Require KYC](#)”
- Coin Desk, “[ShapeShift Is Going Full DeFi to Lose KYC Rules](#).” Crypto exchange ShapeShift got rid of its entire trading desk and restructured in order “to get rid of know-your-customer (KYC) regulations.”

While the cryptocurrency lobbying community will claim they are merely “protocols,” the developers set up websites to easily access the protocols, often creating governance tokens which give token holders the ability to vote on the future of the platform. Some of these governance systems of so-called “decentralized” platforms are themselves rather centralized.

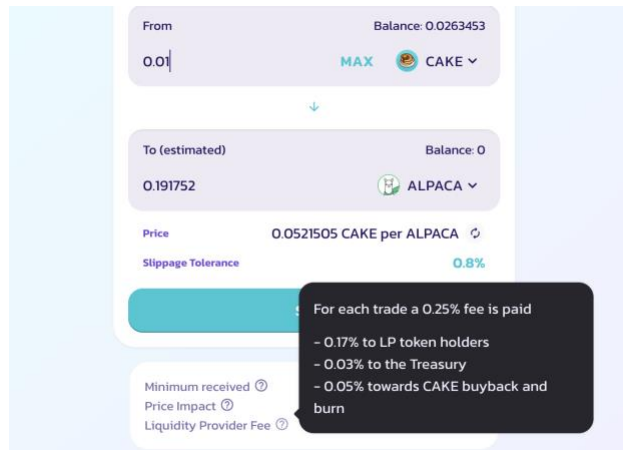
For example, Uniswap only allows users with [0.25% of the outstanding UNI tokens](#) to submit proposals to change the future of the platform. This sometimes leads to controversies, such as when Harvard Law’s Blockchain and Fintech Initiative suggested (and passed) a proposal to take 1 million UNI tokens out of the Treasury and used them to pay a [team of lobbyists to create a DeFi education fund](#).

There is also a large venture capital presence in the space. For example, Uniswap held a Series A in August 2020, raising \$11 million from Andreessen Horowitz and Union Square Ventures, among others.

In addition, many DeFi platforms charge and collect fees:

- SushiSwap charges users a [0.05%](#) “protocol incentive” fee on each trade.
- PancakeSwap (which also hosts a [Lottery](#) and “[Prediction](#)” markets) charges a 0.03% fee for its Treasury and a 0.05% “CAKE buyback and burn” fee.

- Many of these exchanges have their own coin — CAKE is the coin on PancakeSwap; they are charging users fees to fund the buyback of their own coin — to “burn” or destroy it — and attempt to keep the price of the coin higher.
- [PancakeSwap’s description of its Treasury fee](#) is: “The treasury funds are used to **cover the expenses involved in running PancakeSwap**. These expenses include **salaries**, audits, prizes, hosting, upkeep, bounties, etc.”



Screenshot of PancakeSwap accessed August 4, 2021, showing the Treasury and buyback fees collected by PancakeSwap.

Uniswap Version 3 (“V3”) has a 0% protocol fee, but as noted in Uniswap’s [V3 whitepaper](#), this can be changed at any time by Uniswap governance through a vote of the majority of the UNI coin holders.

If these firms, which claim no hand in the transactions themselves, can find a way to collect the fees that make them billion-dollar investment targets, then they can find a way to collect tax compliance information, too.

From collection of user fees to sophisticated governance systems — it’s clear that DeFi protocols and firms have the technical know-how and sophistication to both implement KYC and furnish tax reports to the IRS.

Policymakers Can Stop Cryptocurrency Tax Evasion and a Deregulatory Race to the Bottom

Should policymakers create explicit carveouts from tax reporting for miners, wallets, and DeFi, it has the potential to create a two-tiered cryptocurrency market — one with tax compliance required, and one without. This could accelerate the development of the very “unregulated shadow financial market” that Commissioner Dan Berkovitz of the Commodity Futures Trading Commission warned about [in a speech in June](#).