The Rundown podcast transcript for Performance Audit report titled ***Reviewing Issues Related to State Cryptocurrency Tax Policies – Released July 2022***

Andy Brienzo, Host and Principal Auditor: [00:00]
Welcome to The Rundown, your source for the latest news and updates from the Kansas Legislative Division of Post Audit, featuring LPA staff talking about recently released audit reports and discussing their main findings key takeaways and why it matters. I'm Andy Brienzo. In July 2022, LPA released a limited scope performance audit examining how Kansas' cryptocurrency tax policies compared to federal policies and best practices. I'm with Matt Fahrenbruch, auditor at Legislative Post Audit, who conducted this audit. Welcome to The Rundown, Matt.

Matt Fahrenbruch, Supervisor and Auditor: [00:35]
Thank you.

Andy Brienzo, Host and Principal Auditor: [00:37]
Okay. First, what are cryptocurrencies? How do they work, and how commonly are they used?

Matt Fahrenbruch, Supervisor and Auditor: [00:44]
At a basic level a cryptocurrency, which depending on the source can also be called a digital or a virtual currency is essentially a digital representation of value. It can function as a medium of exchange and/or a store of value. Cryptocurrencies use encryption to secure transactions that are recorded on a digital public ledger. Probably the most well-known is the Bitcoin blockchain. This digital ledger is maintained by a decentralized network of users who work to validate transactions as they occur. So, if you think of it as a

standard financial ledger of a bank or a credit card company, which tracks the movement of U.S. dollars or other official currency between accounts, a cryptocurrency ledger is similar in that it tracks the movement of cryptocurrency from one owner to another. Cryptocurrencies however are designed to be used without a centralized processor like a bank or a credit card company. To do this, exact copies of the cryptocurrency ledger are maintained by each member of the Ledger's network. Now this could be hundreds or thousands of members. So, these are large networks. This distributed ledger technology helps ensure accuracy and transparency of the transactions. So, now in terms of the use of cryptocurrency, it can be used to buy some property goods or services. There have been several large retailers that have started accepting cryptocurrencies in recent years. For example, the more popular use has probably been as a speculative investment. So, a person might hold or trade cryptocurrency just like one would a stock, bond, foreign currency, basically in hopes of the value going up. It should be said, however, that while popular media has raised the public's attention to cryptocurrencies and especially the outsized price gains in some cryptocurrencies in recent years. A 2021 Pew survey found that only about 16% of American adults have reported actually using cryptocurrency. So, its use is still relatively uncommon - at least in the U.S.

Andy Brienzo, Host and Principal Auditor: [02:55]
Now the report outlines an example of how cryptocurrency transactions work. Walk me through that.

Matt Fahrenbruch, Supervisor and Auditor: [03:02]
So in the report, we use the example of person, a transacting with one Bitcoin. Say Person A buys one Bitcoin from Person B on March 1st, 2022. This purchase could be made with basically whatever person B agrees to sell their Bitcoin for. That could be U.S. dollars, it could be another currency, another cryptocurrency, other property goods or services, basically anything. If the transaction is approved by the Bitcoin network. An entry will be added to the blockchain for that time and Person A will receive a private key that allows them to access that Bitcoin similar to a pin number used to access a bank account. Users hold their private keys in digital wallets, which are special hardware, such as flash drives or hard drives or software applications designed for storing and transferring private keys. It's similar to a bank account. Each wallet has a public address called a public key that is used when receiving cryptocurrency.

Matt Fahrenbruch, Supervisor and Auditor: [04:03]
So, you can think of that kind of as a bank account number. Wallets can be custodial, meaning they're hosted by third parties like cryptocurrency exchanges, which are businesses that help users buy, sell, receive, and send cryptocurrency, or they can be non-custodial and controlled solely by their owners without a third-party intermediary. So, back to the previous example, say the above transaction is approved and Person A now has one Bitcoin. Now say Person A wants to buy something – goods, services, property, whatever, from person C with their one Bitcoin and say that happens on March 30th, 2022. Person A will use their wallet and private key to initiate a transaction with Person C's wallet. The transaction will likely be approved by the Bitcoin network because the ledger will show the original purchase of the Bitcoin by Person A on March 1st. Now that entry in the ledger, that is what determines ownership. So, after the transaction is approved, Person C will receive a private key for their new Bitcoin and there will be now be a second ledger entry showing the transfer of the Bitcoin from the wallet address of Person A to the address of Person C. If Person A later tried to use the same key, the Bitcoin network would deny the transaction because there would be an entry in the ledger that shows that Bitcoin was transferred to Person C on March 30th and the key would no longer be valid.

Andy Brienzo, Host and Principal Auditor: [05:32]
So how does the federal government tax cryptocurrencies?

Matt Fahrenbruch, Supervisor and Auditor: [05:37]
So, the federal government does not recognize cryptocurrencies as legal tender, despite the name currency. Instead it views them as property. This is important because it impacts how some cryptocurrency transactions are taxed. Generally speaking, most transactions in cryptocurrency will be taxed the same as if there were U.S. dollar transactions. So, if a merchant accepts cryptocurrency as a payment, or if an employee receives wages in cryptocurrency, or if an investor realizes a gain from cryptocurrency trading, all these transactions would be subject to the same types of income payroll, capital gains taxes as similar U.S. dollar denominated transactions. A caveat to this is that because the IRS does not recognize cryptocurrencies as legal tender, the value of these transactions needs to be reported in U.S. dollars, not in the cryptocurrency used. So, an example of this could be, if you sold a $40,000 car for one Bitcoin, let's say you would report $40,000 on your taxes, not one Bitcoin. Now the value of cryptocurrency transactions are typically determined by the exchange rate of the cryptocurrency with U.S. dollars. So, recently the IRS estimated that there are over 8,600 different

cryptocurrencies. Now the vast majority of these have U.S. dollar exchange rates, but if there was a case where there was not an exchange rate, the value of the transaction would be the dollar value of the goods, property, or services sold, basically what you would sell the goods, property, or services to a dollar paying customer. So, one tax situation that is unique due to the IRS's treatment of cryptocurrencies as property is the use of cryptocurrency to make purchases. So, if you were to go out and buy a $40,000 car with US dollars you would pay your sales tax, your registration, your fees, and that's basically it. However, if you were to buy that $40,000 car with one Bitcoin, because Bitcoin is considered property, the purchase is considered an exchange of property and the buyer would need to determine if they would profit from that exchange. Now, what does that mean? If the buyer only paid $10,000 for that Bitcoin say they bought it several years ago before the recent run up in value, they would be subject to a capital gains tax of $30,000, because that is the difference in value between the original cost of that Bitcoin to the buyer and the value of the new car property that they're purchasing. So, that is a caveat to keep in mind in terms of taxation of cryptocurrencies.

Andy Brienzo, Host and Principal Auditor: [08:16]
And how does the State of Kansas tax cryptocurrencies?

Matt Fahrenbruch, Supervisor and Auditor: [08:21]
So, when we talk about the State of Kansas, the Kansas income tax code, largely mirrors the federal tax code. And that's because since the 1970s, the Kansas tax code has been in conformity with the federal code. This means that Kansas adopts federal tax policies as the basis for their tax code, which is fairly common across the United States. States do this to basically simplify their own tax codes, reduce burden on taxpayers, and then also reduce State burden for audits and non-compliance enforcement. So, what this looks like in Kansas is Kansas uses the federal adjusted gross income for individuals or the corporate federally taxable income for corporations as its starting point for calculating state income taxes. So, basically if income is taxed at the federal level, it's going to get taxed at the Kansas level. Now in terms of sales tax, which is not levied by the federal government, the Kansas Department of Revenue has issued guidance to merchants who accept cryptocurrency as payment like the federal government the Department of Revenue does not consider cryptocurrency to be legal tender and does not accept cryptocurrency for any payment or remittance. Department of Revenue notice 20-04, which was issued in 2020, requires retailers and service providers that accept cryptocurrency to calculate and remit sales tax in U.S.

dollars, similar to the federal government. Different from the federal government, however, the Department Revenue requires that the transactions be valued based on the value of the property goods or services sold not the exchange rate.

Andy Brienzo, Host and Principal Auditor: [10:05]
Now the report notes that due to the lack of third-party reporting of cryptocurrency income, cryptocurrency transactions often aren't taxed at the Federal level. And because Kansas uses the federal AGI and FTI calculations as the starting points for its income tax calculations, as you just mentioned, this also prevents reporting and taxing cryptocurrencies at the state level. So, tell me more about this problem and the possible solutions that you learned about.

Matt Fahrenbruch, Supervisor and Auditor: [10:35]
Sure, many sources of income, like wages or investment income are subject to third party reporting. So, this could be an employer reporting their employees' wages to the federal government on a W-2 form or a banker investment brokerage reporting investment income on a 1099 form. These are examples of third-party reporting where the IRS is not relying on the taxpayer to report their income because another third party is doing so. So, third-party reporting is a good thing for the IRS because they have found that about only about 45% of taxpayers accurately report their income in cases where there is little or no third-party reporting. The problem when it comes to cryptocurrency transactions is a recent U.S. Treasury audit determined that there's a lack of third-party reporting of cryptocurrency transactions and that this makes it difficult for the IRS to identify taxpayers with cryptocurrency income that are not properly reporting. Because Kansas' tax code is in conformity with the Federal code and Kansas relies on the Federal government to identify taxable income. If cryptocurrency income is not reported in the federal adjusted gross income or the corporate federally taxed income, it will not be taxed in Kansas. Now in terms of the potential impact of this on Kansas income tax revenues, Kansas Department of Revenue was not able to estimate tax revenues from cryptocurrency specific income because the data they receive from the IRS through the conformity agreement is not detailed enough to determine the source of income that makes up the adjusted gross income or federally taxable income. They were able to estimate, however, the number of tax returns filed in Kansas in 2021 that likely included cryptocurrency income. So, this estimate came from a question that the IRS started asking on the federal individual tax form in 2020. It's a yes or no question that asks if the filer had any cryptocurrency

transactions. Using these data, Kansas Department of Revenue reported to us that about 20,000 of the 1.5 million returns filed in Kansas in 2021 included a federal return where the filer answered yes to this question. So, in terms of dealing with non-compliance, the federal government is taking action. The same U.S. Treasury audit, I mentioned earlier, highlighted third party cryptocurrency exchanges as a good source of third-party information because of the role they play in facilitating cryptocurrency transactions, Recent estimates cited by the Rand Corporation also suggests that over 90% of cryptocurrency transactions are done through an exchange. The Federal Infrastructure Investment and Jobs Act passed in 2021 included provisions that mandate that cryptocurrency exchanges annually report customer information and transactions to the IRS starting in 2023. It should be said, however, that third party reporting by cryptocurrency exchanges will likely not solve all the issues of non-compliance. There is still uncertainty about what can be done to identify transactions done with non-custodial wallets. These are wallets that are not hosted by a third-party exchange or other third-party intermediaries. Cryptocurrencies are designed to be used without third party intermediaries. While almost all transactions use exchanges, now increased regulation could cause more users to conduct their transactions outside of a third-party setting.

Andy Brienzo, Host and Principal Auditor: [14:12]
As part of this audit, you also reviewed other State's legislation and talked to an official from the national conference of State legislatures about cryptocurrency best practices. What did you learn?

Matt Fahrenbruch, Supervisor and Auditor: [14:24]
Yeah, we found since 2015 that at least 43 bills have been introduced in 22 states related to cryptocurrency taxation. Now these bills range in, in theme from proposals to tax cryptocurrency transactions, regulate the use of cryptocurrencies to pay for things like government taxes and fees, and also bills to incentivize cryptocurrency processing such as cryptocurrency miners and their activities in states. In our conversation with the National Conference of State Legislatures, we were told that a major hurdle to the creation of best practices has been the complexity and instability in the cryptocurrency industry. We were basically told that new crypto products are constantly being developed in state lawmakers and regulators are really trying to keep up with these changes and trying to determine how cryptocurrencies fit within their legal frameworks. To demonstrate this, of the 43 bills mentioned before, only two of those bills have actually been enacted as of March 2022.

Andy Brienzo, Host and Principal Auditor: [15:27]
What's the main takeaway of this audit?

Matt Fahrenbruch, Supervisor and Auditor: [15:30]
So, I would say the main takeaway is that Kansas' treatment of cryptocurrencies are tied largely to federal tax code, at least for income tax purposes. This is due to tax code conformity. At the federal and state levels, the instability in the cryptocurrency industry has really slowed the process of policy creation, but policies are being developed and education enforcement actions are increasing and should continue to increase in coming years.

Andy Brienzo, Host and Principal Auditor: [15:57]
Matt Fahrenbruch is an auditor at Legislative Post Audit. He conducted a limited-scope performance audit, examining how Kansas' cryptocurrency tax policies compared to Federal policies and best practices. Thanks for joining me, Matt.

Matt Fahrenbruch, Supervisor and Auditor: [16:12]
Absolutely.

Andy Brienzo, Host and Principal Auditor: [16:13]
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