

IRS Prepares for Battle on Cryptocurrency Reporting

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In this article, Wood and Smeltzer warn that the IRS is gearing up for audits and investigations regarding cryptocurrencies.

This discussion is not intended as legal advice.

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The IRS issued official guidance on cryptocurrency in 2014, and not again until 2019.¹ The recent guidance was a welcome sign, but it still leaves cryptocurrency investors with many unanswered questions. The IRS continues to promise further guidance, but also warns of

¹See IRS, “Virtual Currency: IRS Issues Additional Guidance on Tax Treatment and Reminds Taxpayers of Reporting Obligations” (Oct. 9, 2019).

enforcement actions against those not in compliance. Also, despite many requests, the IRS shows no signs of implementing an amnesty program similar to programs for foreign account reporting.

IRS Hunts Unreported Cryptocurrency

Although the IRS has been slow with cryptocurrency tax reporting guidance, public comments threatening enforcement action appear regularly. In 2018 the IRS announced a virtual currency compliance campaign to address tax noncompliance regarding the use of digital currency through outreach and examinations of taxpayers.² The IRS says it will remain actively engaged in addressing noncompliance concerning digital currency transactions through a variety of efforts, ranging from taxpayer education to audits and criminal investigations.

For some time now, the IRS has been hunting user identities with software. One IRS investigation receiving considerable press was the John Doe summons issued to Coinbase. A normal IRS summons seeks information about a specific taxpayer whose identity is known; a John Doe summons, as the name implies, involves taxpayers in a group the IRS cannot identify by name — yet. With judicial approval, a John Doe summons allows the IRS to obtain the names of all taxpayers within that group.

This is exactly what happened with Coinbase, resulting in the release of information for 13,000 customers. Coinbase told those affected that it would turn over personal information and transaction records from 2013-2015 to the IRS. The Coinbase summons is unlikely to be the last John Doe summons issued to companies dealing in

²See IRS, “IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns” (July 2, 2018).

cryptocurrency. The IRS and Justice Department Tax Division have enjoyed several victories in John Doe summons cases because of the relatively low burden of proof.

For example, the government recently won enforcement of a John Doe summons issued to a Texas law firm for client files.³ In that case, the U.S. District Court for the Western District of Texas acknowledged that the government's "slight" burden can be met by a "simple affidavit," and it relied on the details of the affidavit submitted by the IRS agent in deciding to enforce the summons. The summons was enforced over the objections of the taxpayer for both abuse of process and attorney-client privilege.

The case is currently on appeal but illustrates the problem a summoned party may face when it wants — or is required — to protect its customers, while hoping to avoid trouble with the IRS. Fighting in court can be expensive and unproductive. Taxpayers with cryptocurrency holdings should expect that, if summoned, the institutions holding their information will probably turn it over to the authorities.

IRS Increases Warnings to Taxpayers

In August 2019 more than 10,000 taxpayers received letters indicating that they may have failed to report income at all, or properly, and to pay the required taxes.⁴ The letters appear tailored to specific taxpayer situations. One variant of the letter requests a response under penalties of perjury.⁵ IRS Commissioner Charles Rettig has urged taxpayers to "take these letters very seriously" and to "amend past returns and pay back taxes interest and penalties."

Rettig also indicated that the IRS is expanding its efforts involving virtual currency including "increased use of data analytics." These 10,000 letters are likely just the beginning. Judith McNamara, director of field operations (international individual compliance) in the IRS Large Business and International Division,

recently stated that, "I would expect that as we get more data, more letters will go out at some point." Even if a cryptocurrency investor didn't receive a letter in this round, they may receive a letter or an audit notice in the next round.

If a taxpayer is invested in cryptocurrency, now is the time to review what they reported, and to correct any mistakes or failures to report. Basic reporting isn't hard and could save taxpayers bigger headaches if the reporting is corrected before being contacted by the IRS. Amending tax returns to ask for big refunds is a well-known audit trigger; amending to report extra income and pay extra tax usually isn't and can stave off more serious problems.

Of course, not everyone will react to this situation or examine their own facts with the same degree of concern. However, the consequences of ignoring crypto-reporting can be serious. The IRS is generally more forgiving if a taxpayer makes corrective filings before being audited or investigated. If you want to be extra careful and limit IRS access to documents, talk with a tax attorney about how to get attorney-client privilege with an accountant.

This is especially a good idea if there are concerns about potential criminal referral, but it can be a wise and low-cost precaution in any event. In sensitive civil or criminal tax matters, the conventional answer is the *Kovel* letter, named after the defendant in that case.⁶ *Kovel* stands for the proposition that you can claim attorney-client privilege with your accountant by having your lawyer hire the accountant.

In effect, the accountant is doing your tax accounting and return preparation but reporting as a subcontractor to your lawyer. Properly executed, it imports attorney-client privilege to the accountant's work and communications. The *Kovel* arrangement generally works well, but it can be less effective with client-accountant relationships that predate the *Kovel* letter. As with the attorney-client privilege, some IRS lawsuits have eroded parts of the privilege.

³ See *Taylor Lohmeyer Law Firm v. United States*, 385 F. Supp. 3d 548 (W.D. Tex. 2019).

⁴ IRS, "IRS Has Begun Sending Letters to Virtual Currency Owners Advising Them to Pay Back Taxes, File Amended Returns; Part of Agency's Larger Efforts" (July 26, 2019).

⁵ IRS, "Reporting Virtual Currency Transaction" (July 16, 2019).

⁶ *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

Failure to Report Can Have Criminal Implications

The IRS is aware that millions of cryptocurrency transactions may still remain unreported. Taxpayers may think they won't get caught, but failure to report is a risky course of action. Many Coinbase users may have thought that their information would be protected until the John Doe summons proved otherwise. The best way to avoid penalties is to disclose and report as accurately as you can, showing that you did not have a willful intent to avoid paying taxes.

Otherwise you could face large financial penalties and potential criminal investigation. Anyone convicted of tax evasion, for example, may face up to five years in prison and a fine that could be as high as \$250,000. Taxpayers may think that the IRS may penalize them, but they might assume that they need not worry about any criminal implications.

However, taxpayers should consider recent actions by the IRS regarding criminal referrals. Rettig has taken actions that indicate a potential increase in the number of criminal investigations. For example, Eric Hylton from IRS Criminal Investigation was recently asked to head the IRS Small Business and Self-Employed Division. Also, Rettig has stated that the current percentage of civil referrals in the Criminal Investigation inventory is unacceptable. This indicates that the number of civil cases turning into criminal investigations may be increasing.

The IRS is also taking steps to build cases against taxpayers who fail to report cryptocurrency. The IRS soft letters mentioned earlier, if received and ignored, can provide evidence of an intentional effort to hide assets instead of an innocent mistake or misunderstanding. The IRS recently released a draft 2019 Form 1040 containing a question targeting cryptocurrency. A checkbox on Schedule 1 requires taxpayers to answer whether at any time during 2019 they sold, sent, exchanged, or otherwise acquired any financial interest in cryptocurrency.⁷

The Justice Department Tax Division has successfully argued that failure to check a box, in the FBAR reporting context, is per se willfulness.⁸ Willful failures, as opposed to non-willful actions, usually carry higher penalties and a greater threat of criminal investigation. The Justice Department Tax Division is working with the IRS and is already involved in several criminal prosecutions involving cryptocurrency and has warned that others are on the way.⁹ The Criminal Investigation Division is also meeting with tax authorities from other countries to share data and enforcement strategies to find potential cryptocurrency tax evasion.

Potential Problems Reporting Cryptocurrency

The IRS 2014 guidance (Notice 2014-21, 2014-16 IRB 938) states that cryptocurrency is not currency for tax purposes; it is property. Because cryptocurrency is treated as property (like stocks or real estate), taxpayers pay taxes if they realize a gain but may be able to claim losses when they realize them. As property, taxpayers must know when they bought the cryptocurrency, how much they paid, and what they received for it.

For some property, such as stocks and real estate, this may be a simple task. For cryptocurrency, it can be more difficult. The IRS FAQs state that all income, gain, or loss involving virtual currency must be reported regardless of the amount or if you received a form W-2 or 1099.¹⁰ Many cryptocurrency investors have made various purchases at multiple times and for many years. Often, the only record of these transactions available to taxpayers are their own logs, if kept.

The IRS guidance indicates that basis is determined by the fair market value of the virtual currency, in U.S. dollars, when the virtual currency is received. If the virtual currency was received from an established exchange, the value may be easily determined. However, if the taxpayer received the virtual currency through

⁸ See *United States v. Horowitz*, 361 F. Supp. 3d 511 (D. Md. 2019).

⁹ See, e.g., Justice Department, "Arizona Man and Israeli Woman Charged in Connection With Providing Shadow Banking Services to Cryptocurrency Exchanges" (Apr. 30, 2019); see also CCN Markets, "US Justice Department & IRS Are in Hot Pursuit of Bitcoin Tax Evaders" (June 25, 2019).

¹⁰ See IRS, "Frequently Asked Questions on Virtual Currency Transactions" (FAQ 39).

⁷ IRS, "Additional Income and Adjustments to Income Form 1040."

peer-to-peer transactions, or if the cryptocurrency itself does not have a published value, it can be considerably messier. The IRS will still require taxpayers to use some reasonable method to value the cryptocurrency and to establish that such value is accurate.

There are various websites available that may offer help in figuring out a taxpayer's transaction history. Some of them will even attempt to estimate amounts owed and fill out the Schedule D form reporting gains and losses. These software programs may not be perfect, and the IRS may be unforgiving of mistakes. However, there is at least one reported case providing support for relief from penalties if the software used is to blame for the mistake.¹¹ Of course, this case does not involve cryptocurrency.

Cryptocurrency investors who mine cryptocurrency may have other issues. For one, they may have trouble deciphering exactly when they *received* mined cryptocurrency for purposes of determining value for reporting purposes. The IRS guidance says that taxpayers must use a reasonable method to determine the fair market value used to determine gain or loss.

Taxpayers can use a first-in, first-out method or some other method as long as it is consistently applied. If taxpayers have not kept a detailed log in the past, then some method must be used for past transactions. Ideally, it will support an argument of best efforts to comply in the past and will help support continuing reporting efforts going forward.

As cryptocurrencies become more common in the marketplace, they can be used to purchase items or services. However, because cryptocurrency is treated as property, every exchange can trigger gain or loss. In many cases, these gains and losses may be capital gains and losses, but even then, the short-term and long-term holding period rules must be observed. There appears to be no threshold on what is taxable if paid for goods or services.

Therefore, taxpayers using cryptocurrency for small purchases could have multiple small reportable gains and losses that must be recorded, reported, and accounted for over the course of the

year. More generally, of course, even with the IRS's recent guidance, significant questions remain. The recent guidance and FAQs do not address specifically how to compute value, how to determine basis, or how estate tax rules apply to cryptocurrency.

There is also the problem that the existing FAQs are not technically legal authority on which taxpayers can rely. For these, and many other issues, taxpayers are still guessing and hoping that making some effort to properly report will help them avoid penalties if they are audited. Even so, the new guidance thankfully does include Rev. Rul. 2019-24, 2019-44 IRB 1004, in addition to the increased FAQs. This new revenue ruling addresses common questions by taxpayers and tax practitioners regarding the tax treatment of a cryptocurrency hard fork and air drops.

Also, the IRS has specifically requested public comments to the recent guidance, providing at least one avenue for input by the taxpaying public. For the time being, the safest course appears to be careful reporting, with amending and reporting for the past as needed. In some cases, normal amended returns or quiet disclosures may be fine.

In other cases, formal voluntary disclosures to the IRS may be appropriate. In either circumstance, it seems wise to use one's best efforts with the current guidance, remaining open to the possibility that one may want to make adjustments later if new guidance is issued. The world isn't perfect, and the IRS's response to cryptocurrencies over the past five years has not been either. But there can be no mistaking the IRS's intent to make big enforcement and revenue drives into this brave new world. ■

¹¹ See *Olsen v. Commissioner*, T.C. Summ. Op. 2011-131.