PERSPECTIVE

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IRS Software Trolls For Bitcoin Users And Then Matches To Taxes

By Robert W. Wood

Is bitcoin still in the IRS crosshairs? Users of bitcoin sure are. In IRS Notice 2014-21, the IRS announced that bitcoin and other digital currency is actually *property* for tax purposes, not currency. That in itself has some big tax consequences. Just consider these.

Wages paid to employees using virtual currency are taxable, must be reported on a Form W-2, and are subject to federal income tax withholding and payroll taxes. If you pay someone in property, how do you withhold taxes? You have to send the IRS money from something else. You either pay the employee some cash and some bitcoin, and withhold extra on the cash, or you sell some of the bitcoin to get dollars to pay the IRS.

Payments using virtual currency made to independent contractors? They are taxable too, and payers must issue Form 1099. You can't enter "1,000 bitcoin" on the Form 1099. You must value it in dollars, as of the time of payment. Valuation swings can be brutal.

Gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in your hands. This point can be a huge issue, and is not an easy subject to summarize. Again, valuation swings matter.

A payment made using virtual currency is subject to Form 1099 reporting just like any other payment made in property. Yes, this bears repeating. How much compliance there is in the real word remains to be seen. It takes time for people to adapt, and that is one reason compliance may be poor so far.

But part of it may also be the nature of digital currency. It is *meant* to be anonymous, and attracts some users for that reason. They may be less inclined to start handing out IRS Forms 1099. Recipients of those forms may go somewhere else.

All of this leaves the IRS wondering how to get a piece of the action. That's where enforcement comes in. Last year, the IRS started fighting to obtain vast amounts of data on bitcoin and other digital currency transactions. In late 2016, a federal court authorized the IRS to serve a John Doe Summons on Coinbase, Inc., the digital currency transaction hub. See *United States of America v. John Doe*, 3:16-cv-06658-JSC (N.D.Cal.).

The IRS wants information on the site's users and their transactions. Some Coinbase users, led by Jeffrey K. Berns, moved to intervene in the IRS's case. They argued that the IRS request threatened their privacy. In turn, the IRS argued that Berns has already identified himself as a user of Coinbase, so he can hardly object that his privacy is threatened. A John Doe Summons is powerful.

It is worth remembering that the IRS used a John Doe Summons to get names of Swiss bank account holders from UBS. Offshore banking changed forever, with all other Swiss (and other) banks following suit. The IRS ended up collecting over $10 *billion*. The IRS is pursuing Coinbase in the same way.

As with Swiss accounts, bigger fish may draw more attention, while minnows may not be worth IRS efforts. As one indication, the IRS dropped its request for customer records from Coinbase to those accounts with transactions over $20,000. Bigger transactions mean bigger taxes, and bigger penalties.

There is no question that the IRS will do more data mining for digital currency users. Reports about compliance suggest that they may need to. Fortune reported IRS claims that only 802 people declared a capital gain or loss related to bitcoin in 2015. This suggests that the bulk — the *vast* bulk — of bitcoin transaction are simply not reported on tax returns.

With millions of transactions and the meteoric rise of bitcoin from under $100 in 2013 to over $4,000 today, the IRS seems to be missing out. Big time. That is where IRS tech comes in. Well, private tech then. It is now widely reported that the IRS is using software to find bitcoin users who have failed to report profits.

The Daily Beast revealed an IRS contract with Chainalysis that is at the root of this new IRS enforcement effort. If Chainalysis identifies owners of digital wallets, the IRS can take over. Matching up transactions and tax returns is not that hard. Taxpayers who have unreported income could face taxes, interest, and potentially big civil penalties.

It is fairly easy for the IRS to add 25 percent penalties to just about anything. If the IRS claims civil fraud, the penalty is 75 percent. Some cases could even end up as criminal tax cases. That is a much deeper category of worry.

In large part, the tax system is still largely voluntary. Everyone must file a tax return, and self-report. Of course, the myriad web of Forms 1099, W-2, tax withholdings, etc., all help you to remember. It can be awfully hard to stay off the grid, even if you are trying.

And that's one of the issues facing users of digital currency today.

Can you really assume that *anything* is anonymous? How do you start to comply when you don't know where to begin? Basic reporting isn't that hard, and you have to start somewhere. Some taxpayers will go forward only, starting to report gains or losses on their *next* tax return.

Some will amend past years, going back one, two, or three years. Amending to ask for big tax refunds is a well-known audit trigger. Amending to report extra income and pay extra tax is much less so. Big offenders might even go back farther than three years, although the IRS often doesn't know what to do with amended tax returns more than three years out.

In all of this, the IRS is generally considerably more forgiving if a taxpayer makes corrective filings before being caught or audited. Those who do not make filings until they are caught usually face harsher treatment. Remember, the IRS treats Bitcoin and other digital currencies as property. For better or worse, that means sales could give rise to capital gain or loss, rather than ordinary income. Be careful out there.

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