Cryptocurrency Criminal Tax Cases Coming Soon

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IRS Criminal Investigation Chief Don Fort recently announced that details on new criminal tax cases involving cryptocurrency will be publicized soon. This news should come as no surprise to those following cryptocurrency developments since Coinbase informed approximately 13,000 of its customers in February 2018 that it was providing the IRS with their taxpayer ID, name, birthdate, address, and historical transaction records during 2013-2015. The production of Coinbase client information to the IRS is the result of an IRS "John Doe" summons that was served on Coinbase in 2016.

It is likely that the forthcoming announcement of these criminal cases relates to the Coinbase summons response. Cryptocurrencies operate through the use of a distributed ledger. As a result, all transactions for a given protocol, for example Bitcoin, are broadcast publicly. However, the details provided—the public address of the sender/receiver, transaction size, and timestamp—afford participants a certain degree of anonymity because the owner of a particular public address is unknown. We believe the IRS has been combing cryptocurrency transaction ledgers using algorithms and Artificial Intelligence to generate leads for CI. The information received by the IRS from Coinbase, coupled with any payment patterns or associated public addresses that arise from a blockchain analysis, could allow the IRS to uncover the owner of the anonymous public addresses. The public nature of transactions on the blockchain makes tracing the payments made to and received by these addresses easy. We suspect the IRS is also very interested in the users and operators of "cryptocurrency tumblers"—a service which takes one users coins, mixes it with coins from others, and returns different coins to the user.

In Notice 2014-21, the IRS announced that cryptocurrencies (referred to as "virtual currencies" in the Notice) would be treated like property, and would result in capital gain or loss treatment upon disposition by the owner. Thus, purchasing a Bitcoin at $600 and selling it five years later for $10,000 would produce a $9,400 long-term capital gain for its owner, with the gain being reportable on Form 8949 in that tax year. Capital asset treatment is much more burdensome for cryptocurrency traders who enter into a high volume of transactions to capitalize on exchange rate volatility. This, of course, is why the Coinbase summons response is so important to the IRS.

While we expect that violations for failing to report gains on the disposition of cryptocurrencies will be largely resolved through civil audits, we will soon receive details on the type of conduct that the IRS believes merits criminal referral. To the extent heavy users of cryptocurrency may be concealing their receipt of any kind of income, such persons may be prime targets of potential criminal inquiries. Subjects of such investigations may have defenses based on lack of willfulness, and may have the ability to exercise certain privileges to protect confidential or incriminating information. Others who transact in cryptocurrency or provide services to them may have the option of mitigating the potential criminal and civil consequences of prior unlawful, even criminal, conduct. Depending on the circumstances, such persons may be eligible to make a voluntary disclosure to the IRS under a longstanding policy whereby the IRS will not refer for criminal prosecution taxpayers who come forward on a timely basis to correct prior tax non-compliance. The IRS recently published new guidelines on this policy laying out the general procedural and penalty approach that would likely apply. To the extent that any involved party may be too late to qualify for a formal voluntary disclosure, there may be other options to minimize the risk of serious repercussions from the non-compliance.

Caplin & Drysdale offers extensive experience in criminal and civil tax controversy. Our lawyers regularly advise individuals and organizations facing criminal and civil tax exposure, and our firm has handled thousands of voluntary disclosures.

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