

Decrypting The New IRS Cryptocurrency Compliance Letters

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Law360 Tax Authority

On July 26, 2019, the Internal Revenue Service announced that it has begun sending what it characterized as educational letters to more than 10,000 taxpayers regarding the potential failure to report income and pay tax from, or improperly reporting, cryptocurrency transactions.^[1] This news follows a recent announcement from IRS Criminal Investigation Chief Don Fort that details on new criminal tax cases involving cryptocurrency will be publicized soon. These enforcement and compliance initiatives are part of the IRS' virtual currency compliance campaign, announced in July 2018, addressing taxpayer noncompliance related to the use of cryptocurrency.

Cryptocurrency Basics

Open-source cryptocurrencies operate through the use of a distributed ledger. As a result, all transactions for a given protocol, for example bitcoins, 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.

A person needs a "wallet" in order to send and receive cryptocurrency. The public address to and from which cryptocurrency is sent or received is derived from this wallet. Additionally, a person can use an "exchange" (e.g., Coinbase) to convert fiat currency (e.g., U.S. dollars, British Pounds, etc.) into cryptocurrency. Once the person purchases cryptocurrency on the exchange, he or she can transfer such cryptocurrency to another wallet (both within and outside of the exchange platform). Such transfers permit, for example, the use of cryptocurrency for the purchase of goods and services.

U.S. Tax Rules Regarding Cryptocurrency

Although taxable transactions conducted in cryptocurrencies were always subject to tax reporting obligations, until five years ago, there was no IRS guidance on the treatment of cryptocurrency. In March 2014, the IRS released Notice 2014-21, announcing that cryptocurrencies (referred to as "virtual currencies" in the notice) would be treated like property. As a result, a taxpayer must recognize gain or loss upon a sale or exchange of the cryptocurrency.

The type of gain depends on whether the cryptocurrency is a capital asset in the hands of the taxpayer. 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, which is reportable on Schedule D for the tax year of the sale.

By choosing to treat cryptocurrency as property, the IRS has created a burdensome task for those looking to utilize cryptocurrency in their lives. A person is required to keep track of their basis in cryptocurrencies (generally, the price paid for each coin or fraction thereof) and the amount realized on a sale or exchange, for whatever purpose. This limits the practical utility of cryptocurrency in everyday life because the record-keeping and reporting of each cryptocurrency transaction requires a unique computation of gain or loss, and the potential payment of capital gains tax on individual transactions.

Whether the IRS so intends or not, its treatment of cryptocurrency as property undoubtedly hinders its proliferation. The following example illustrates the complexity of tracking and properly reporting cryptocurrency transactions.

Suppose a taxpayer sells appreciated property for five units of cryptocurrency. The taxpayer must determine the fair market value of the cryptocurrency on the date of the sale to determine whether there is any reportable gain on the sale of the property and also to fix the taxpayer's basis in the currency. The following year, the same person purchases an item for two units of cryptocurrency. The taxpayer must determine the fair market value of the item received in U.S. dollars on the date of the purchase to determine whether there is a taxable gain or loss, and if there is a gain, tax is owed.

If the taxpayer had no other cryptocurrency transactions and used the two units out of the five received on the property sale, the computation, while burdensome, is straightforward. But if the taxpayer routinely engages in the purchase of cryptocurrency and then uses it in everyday transactions, the taxpayer is required to do that same computation each time, whether the currency is used to acquire assets or exchanged for fiat currency. The bookkeeping can be incredibly complex, and in a rising cryptocurrency market, a taxpayer can incur substantial additional tax simply by using currency acquired long ago to purchase goods or services now.

IRS Enforcement Efforts

The timing of the recent IRS announcements is unsurprising to those following cryptocurrency developments. In December 2016, the IRS served a "John Doe" summons on Coinbase requesting information relating to Coinbase's U.S. customers who conducted transactions in cryptocurrency between Jan. 1, 2013, and Dec. 31, 2015.

Coinbase filed a petition to quash the summons in the U.S. District Court for the Northern District of California. In May 2017, members of the Senate Finance Committee and the House Ways and Means Committee wrote to John Koskinen, the IRS Commissioner at that time, questioning the breadth and intrusiveness of the Coinbase summons and requesting that the IRS answer questions related to the IRS' policies and procedures relating to cryptocurrency.

Shortly thereafter, the IRS narrowed the scope of its summons request. On Nov. 28, 2017, the court denied Coinbase's motion to quash and ordered Coinbase to respond to the summons, albeit as further narrowed by the court. In February 2018, Coinbase informed approximately 13,000 of its customers that it was providing the IRS with their taxpayer ID, name, birthdate, address and historical transaction records during 2013 through 2015.

The IRS believes that tax noncompliance associated with cryptocurrency is widespread. The Coinbase summons response is thus important to the IRS, and it is likely that the combined issuance of the IRS letters and the forthcoming announcement of the criminal cases largely derive from the information obtained pursuant to that summons.

The Letters

The IRS is sending three versions of the letter to taxpayers.

Letter 6174 and Letter 6174-A each notify a taxpayer that the IRS has information regarding the taxpayer's account(s) containing virtual currency. They provide a high-level overview of virtual currency activity that may trigger reporting obligations, the tax schedules on which such activity is reportable and identify additional informational resources. Although both letters explicitly state, "You do not need to respond to this letter[.]" Letter 6174-A warns recipients that additional correspondence about potential enforcement activity may follow. Among other things, these letters are meant to put taxpayers on notice of the applicable rules, which would make further noncompliance a more serious issue.

The third version of the letters, Letter 6173, requires a response under a deadline. This letter appears to be directed at taxpayers that the IRS knows - or strongly suspects - have unreported income from virtual currency transactions. Letter 6173 informs the taxpayer that they need to either (1) file delinquent returns reporting the virtual currency transactions, (2) file amended returns to report virtual currency transactions or correct the income, gain, or loss calculation reported on a return or (3) provide a statement of facts, signed under penalty of perjury, explaining why the taxpayer believes he or she has complied with all of the IRS's reporting requirements.

It is also likely that the IRS has been combing cryptocurrency transaction ledgers using algorithms and artificial intelligence to generate leads for the IRS Criminal Investigation Division. The Coinbase information in the hands of the IRS, coupled with any payment patterns or associated public addresses that arise from a blockchain analysis, could allow the IRS to uncover the owners 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" or "mixers" - a service used to enhance the anonymity of cryptocurrencies by taking users' cryptocurrency and mixing it with funds of other users and redistributing the commingled funds to its users.

While we expect that violations for failing to report gains on the disposition of cryptocurrencies will be largely resolved through civil audits, the willful violation of tax reporting requirements can be a criminal offense, and we anticipate soon learning details on the type of conduct that the IRS believes merits criminal referral. To the extent heavy users of cryptocurrency may be concealing receipt of any kind of taxable income, such as wages or rental income, such persons may be prime targets of potential criminal inquiries, and this is more likely if a taxpayer has engaged in any transaction with cryptocurrency derived from unlawful activity. Subjects of such investigations may have defenses based on lack of intent or willfulness or the reliance on professional advisers and may have the ability to exercise certain privileges to protect confidential or incriminating information. Any taxpayer approached by criminal tax investigators has the right to decline to answer their questions and should consider immediately contacting counsel.

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 facts and circumstances of each case, such persons, including recipients of the IRS' recent letters, may still be eligible to make a voluntary disclosure to the IRS, provided the unreported cryptocurrency income is from legal sources.

Under the IRS' longstanding voluntary disclosure policy, the IRS will not refer for criminal prosecution taxpayers who voluntarily come forward on a timely basis to correct prior tax noncompliance. In 2018, the IRS published new guidelines in connection with this policy, laying out the general procedural guidelines and penalty structure that would likely apply. This new iteration of the voluntary disclosure policy is untested in the

context of a large letter campaign such as the issuance of these three letters to thousands of cryptocurrency users.

The appropriate approach for the IRS would be to take the view that the mere receipt of one of the IRS' letters should not disqualify a taxpayer from making an acceptable voluntary disclosure. This would be consistent with the IRS Criminal Investigation Division's traditional enforcement models in similar circumstances over the years. However, if the IRS were to decide that a particular taxpayer is too late to qualify for a formal voluntary disclosure, or the previously unreported cryptocurrency income is from illegal sources, there may be other options to minimize the risk of serious, and potentially criminal, repercussions from the cryptocurrency-related noncompliance.

With the IRS' increased focus on the tax reporting of cryptocurrency transactions, anyone who engaged in such transactions, and especially any taxpayer who received one of the IRS' letters, should review their prior tax returns and consider options available to address any identified prior noncompliance.

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