

The Tax Adviser

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IRS closer to obtaining virtual currency records

Now that a federal district court has ruled that a narrower version of the IRS's summons to Coinbase can be enforced, Coinbase's customers should beware.

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January 11, 2018

U.S. taxpayers who have traded in virtual currencies such as bitcoin, but have not reported and paid tax on the income or gains from those transactions, may face the heat as the IRS continues to press for greater tax compliance in the virtual currency arena.

Some taxpayers may evade their tax obligations by concealing or otherwise failing to report their proper amount of taxable income and thus underpay their taxes, according to the IRS, and the Service has identified several tax-compliance risks associated with virtual currencies, including a lack of third-party reporting.

Tax practitioners should understand how virtual currency transactions work because their clients may already be trading in virtual currency or will be in the near future.

Documents requested by the IRS

The government has been investigating the use of virtual currency that can be converted into traditional currency for the past several years. After the IRS issued Notice 2014-21, which took the position that transactions in virtual currency were property transactions that could result in gain or loss, it then served a John Doe summons on Coinbase Inc., a San Francisco-based virtual currency exchange company, in November 2016. (A John Doe summons, which is issued under Sec. 7609(f), does not name a taxpayer because the IRS does not know the person's name.)

Most recently, on Nov. 30, 2017, after a lengthy summons enforcement proceeding, a federal district court issued an order granting in part and denying in part the IRS's petition to enforce the summons. The court's order (*Coinbase, Inc.*, No.17-cv-01431-JSC (N.D. Cal. 11/28/17) (order re: petition to enforce summons) requires Coinbase to produce the following documents for accounts with at least the equivalent of \$20,000 in any one transaction type (buy, sell, send, or receive) in any one year during the 2013 to 2015 period:

1. The taxpayer identification number;

2. Name;
3. Birthdate;
4. Address;
5. Records of account activity; and
6. All periodic statements.

Once the documents are produced, the IRS will begin sifting through a vast amount of information to identify U.S. taxpayers who the IRS believes are not complying with their tax obligations. Those taxpayers may be subject to civil examinations and potentially owe tax, interest, and civil penalties. Other taxpayers with more serious issues could become subject to criminal investigation — if, for example, they have large amounts of unreported income over several years.

All of this is yet to be determined as the *Coinbase* case plays out. Taxpayers who think they may have exposure would be wise to take steps to comply, such as participating in the IRS domestic or offshore voluntary disclosure programs, as opposed to waiting for the IRS to catch them.

Notice 2014-21

The IRS laid the groundwork for enforcement in the virtual currency world by issuing Notice 2014-21, which provides answers to frequently asked questions (FAQs) on virtual currency, such as bitcoin. The 16 FAQs in the notice discuss the U.S. federal tax implications of transactions in, or transactions that use, virtual currency. For taxpayers trading in virtual currency, the notice is an important document to understand, and for tax professionals, the notice is a must-read. The IRS also updated its website in March 2014 to include a landing page specifically dedicated to virtual currency and providing an overview of the rules and a link to Notice 2014-21.

The IRS's position is that virtual currency is treated as property for federal tax purposes and that general tax principles that apply to property also apply to transactions using virtual currency (Notice 2014-21, FAQ No. 1). This means that a taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value (FMV) of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received (FAQ No. 3).

Taxable income from buying goods or services

Suppose a U.S. taxpayer, *J*, located in Mountain View, Calif., performs software contracting services in 2015 for a client, *M*, located in the Netherlands. *J* emails *M* an \$8,500 invoice for the work. Instead of sending a check from the Netherlands, *M* pays *J* for his consulting services by electronically transferring bitcoin to *J*'s virtual currency account.

Since the virtual currency is convertible, *J* cashes out and electronically transfers the funds to his personal bank account. Under Notice 2014-21, *J* has taxable income equal to the bitcoin's FMV on the date that *J* received the virtual currency from *M* (i.e., \$8,500). The income is also probably self-employment income subject to self-employment tax (FAQ No. 10).

Taxable gain from buying, selling, or trading

In addition, other transactions using virtual currency trigger a reporting requirement. A taxpayer can have gain or loss upon an exchange of virtual currency for other property just as if a taxpayer sold property and in exchange received cash. Below is a quick summary of the rules:

- If the FMV of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency (the taxpayer's cost to purchase the virtual currency), the taxpayer has taxable gain.
- A taxpayer has a loss if the FMV of the property received is less than the adjusted basis of the virtual currency (FAQ No. 6).

Capital gain or loss for property transactions, including those from virtual currency, is reported on Form 4797, *Sales of Business Property*, which is attached to Schedule D, *Capital Gains or Losses*, of a federal income tax return.

Adjusted basis of virtual currency

A critical aspect in dealing in virtual currency, and an important step that tax practitioners can assist their clients with, is maintaining adequate books and records to establish a taxpayer's adjusted basis of the virtual currency. A taxpayer's adjusted basis (or cost to purchase the virtual currency) determines the amount of taxable gain or loss.

If a taxpayer becomes the subject of a civil examination, the taxpayer, not the IRS, has the burden of proving cost basis, which normally is accomplished through contemporary documentary evidence. Without credible evidence, the IRS can take the position that the property received in the exchange is fully taxable because it has no basis.

John Doe summons

On Nov. 17, 2016, the government filed an *ex parte* petition under Sec. 7609(h)(2) for an order permitting the IRS to serve a John Doe administrative summons on Coinbase, the San Francisco virtual currency exchange company, for information related to transactions conducted in convertible virtual currency (*In re the Tax Liabilities of John Does*, No. 3:16-cv-06658-JSC (N.D. Cal. 11/17/16)). The IRS sought the identity of U.S. persons who had not properly reported income from their use of virtual currency.

A John Doe summons is a powerful tool for the government to discover the identity of individuals who may have failed to disclose all of their income (see *Bisceglia*, 420 U.S. 141 (1975)). Unlike a normal summons seeking information about a specific taxpayer whose identity is known, a John Doe summons seeks information about a group of taxpayers (Secs. 7609 (c)(3) and 7609(f); see also Internal Revenue Manual (IRM) §25.5.7, "Special Procedures for John Doe Summonses"). The IRS may issue a John Doe summons only after a court proceeding in which the government meets three requirements:

1. The summons relates to the investigation of a particular person or ascertainable group or class of persons;
2. There is a reasonable basis for believing that the person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law; and
3. The information sought is not readily available to the IRS from other sources (Sec. 7609(f)).

Unlike a normal court hearing, where both sides submit briefs and participate in the hearing, the court decides

the case based only upon a review of the government's petition and supporting documents (Sec. 7609(h)(2)). Coinbase was not permitted to appear in court or to file briefs. An important takeaway is that the government only needs to establish a *reasonable basis* for believing that a group or class of persons has failed or may have failed to comply with any provision of any internal revenue laws. No further showing is required.

In the *Coinbase* case, the government pointed to the following evidence, set forth in its pleadings, in support of its petition to enforce the summons:

1. A report issued by the U.S. Government Accountability Office (GAO) regarding tax compliance issues relating to virtual currency;
2. Notice 2014-21, where the IRS set forth its position that virtual currencies that can be converted into traditional currency are property for tax purposes;
3. A second GAO report issued in May 2014 focusing on public policy challenges posed by the use of virtual currencies; and
4. A signed declaration by an IRS senior Revenue Agent, who had gathered information regarding tax compliance issues posed by the use of virtual currency (*In re the Tax Liabilities of John Does*, No. 3:16-cv-06658-JSC (N.D. Cal. 11/17/16) (memorandum in support of *ex parte* petition for leave to serve John Doe summons)).

After reviewing the government's petition and supporting documents, on Nov. 30, 2016, the federal district court issued an order granting the *ex parte* petition for leave to serve a John Doe summons on Coinbase (*In re the Tax Liabilities of John Does*, No. 3:16-cv-06658-JSC (N.D. Cal. 11/30/16) (order granting *ex parte* petition for leave to serve "John Doe" summons)).

Summons enforcement proceedings

When the IRS served the John Doe summons on Coinbase, the company refused to comply, so the government filed a petition in federal district court to enforce it. On Nov. 28, 2017, after briefing and an oral hearing, the court issued an order enforcing the summons. A few observations are worth noting about the summons enforcement proceeding in federal district court:

- The court found that the IRS summons served a *legitimate purpose* of investigating the reporting gap between the number of virtual currency and bitcoin users reporting gains or losses to the IRS. The court relied, in part, on the IRS's assertion that only 800 to 900 taxpayers reported bitcoin gains to the IRS during each of the relevant years.
- However, the court ruled that the summons went beyond seeking relevant information and narrowed the scope to a limited category of documents.
- The court's opinion provides insight into the scope and type of documents the government can obtain in a summons enforcement proceeding dealing with a virtual currency exchange company.

What to expect

The next step is for the IRS to begin sifting through the Coinbase data and identifying U.S. taxpayers who the IRS believes are not complying with their tax obligations by comparing the information received from

Coinbase with information reported by taxpayers on their returns. Some U.S. taxpayers may be selected for audit.

The IRS will be looking for unreported income (e.g., gain from the sale or exchange of virtual currency based upon a review of a taxpayer's periodic account statements), and taxpayers may face, at a minimum, the civil accuracy-related penalty (a 20% penalty under Sec. 6662) and possibly the civil fraud penalty (a 75% penalty under Sec. 6663). In cases with larger amounts of unreported income over a number of years, the IRS could refer the case to IRS criminal investigation (see Fink, 1 *Tax Controversies: Audits, Investigations, Trials* §5.01 (2017)).

Looking forward

The best course of action now for U.S. taxpayers who have used virtual currencies is to take steps to comply and minimize their exposure through, for example, the IRS voluntary disclosure process. Cases are harder to resolve, and the civil penalties can be greater, after the IRS contacts a taxpayer. Expect the IRS to be most interested in U.S. taxpayers who have traded in virtual currency. If a taxpayer is contacted, however, the following points are worth considering for tax professionals representing a client during a tax audit:

1. Although the government has issued its position in Notice 2014-21 that virtual currency transactions are taxable as property, it is uncertain whether certain virtual currency transactions are actually subject to U.S. taxation. Tax professionals should carefully review the virtual currency exchange transactions, get a handle on the facts early on, and develop a defensible strategy as to the amount of unreported income.
2. Notice 2014-21 recognizes that penalty relief may be available to taxpayers who are able to establish that the underpayment of tax is due to reasonable cause.
3. Where the law is vague or unsettled on whether a transaction has generated taxable income, courts have found that the defendant lacked willfulness, which is a defense to tax evasion or the civil fraud penalty (Office of Chief Counsel, Criminal Tax Division, *IRS Tax Crimes Handbook*, p. 10 (2009), citing *Harris*, 942 F.2d 1125, 1131 (7th Cir. 1991) (involving payments by wealthy widower to mistresses where civil tax cases had held such payments were gifts); *Garber*, 607 F.2d 92, 100 (5th Cir. 1979) (novel issue of tax treatment of money received from sale of rare blood)). There is no question that taxation of virtual currency transaction is a relatively new and complex area of tax law.
4. A good-faith misunderstanding of the law or a good-faith belief that one is not violating the law is a defense to willfulness (e.g., tax evasion or civil fraud penalty); a taxpayer simply may not have known that he or she had to report and pay tax on certain virtual currency transactions that the taxpayer had not converted into traditional currency (*Cheek*, 498 U.S. 192 (1991); *Stadtmauer*, 620 F.3d 238 (3d Cir. 2010)).

Compliance is key

Virtual currency tax cases are a new and evolving area of the law, and further developments are expected as cases begin to be worked by IRS agents and eventually wind their way through the agency and the courts. U.S. taxpayers who have traded in virtual currency would be wise to seek the advice of competent tax counsel, who can evaluate the case, explain the options, and develop a defensible strategy.

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