Virtual Currency Reality: The IRS Crack Down on Cryptocurrency

By Guinevere Moore

Guinevere Moore examines the IRS crack down on cryptocurrency.

Cryptocurrency is now 10 years old. Until October 9, 2019, the IRS had issued exactly one piece of guidance on taxation of cryptocurrency. Some taxpayers who have earned, bought, sold or received virtual currency have done their best to determine and comply with their federal income tax obligations despite this lack of guidance. Others have failed to report their virtual currency transactions, unaware that virtual currency is subject to taxation or blindly hoping that the IRS will not find them. The need for additional guidance on the tax treatment of virtual currency is obvious, but the IRS is not waiting for such guidance to be issued before enforcing the tax laws. Instead, the IRS has made virtual currency tax enforcement a priority both in the civil and criminal divisions of the agency. On October 9, 2019, the IRS issued additional guidance on the tax treatment of virtual currency, including Rev. Rul. 2019-24 and Frequently Asked Questions and Answers regarding virtual currency taxation. Taxpayers who have virtual currency need to get real about the IRS.

Virtual Currency Basics

Cryptocurrency, or virtual currency, has been around since 2009. Cryptocurrency such as Bitcoin was developed to be a peer to peer direct payment system.[1] Instead of writing a check that needs to clear through a bank and the banking system, individuals can pay each other in Bitcoin, directly. Virtual currency is like a currency, because it is a payment system. It can be used to pay for goods or services. But virtual currency is also *not* like a currency. It is not backed by any government and it is entirely intangible. Images of Bitcoin abound, but those are more like symbols that stand for Bitcoin than anything else. You can't hold a Bitcoin or any other virtual currency in your hand.

Bitcoin was the first publicly traded virtual currency in 2010.[2] It began trading at less than $0.01 per Bitcoin and rose to over $30 per Bitcoin by June of 2011.

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The price remained highly volatile for years, climbing to over $1,200 per coin in November of 2013 and falling to $600 in December of 2013.[3] The price of a Bitcoin in September 2019 has hovered around $10,000.[4] There are over 1,000 different types of virtual currency today. As Bitcoin's trading volume and price steadily rose, guidance was needed regarding how virtual currency should be treated for tax purposes. Congress has not enacted legislation regarding virtual currency taxation, but the lack of statutory guidance hasn't slowed down investors in this market.

Virtual Currency Guidance from the IRS

In 2014, the IRS issued the first guidance regarding taxation of virtual currency. IRS Notice 2014-21 contains six pages of instructions regarding how "existing tax principles apply to transactions using virtual currency."[5] The Notice contains 16 Frequently Asked Questions ("FAQs") and answers regarding virtual currency taxation. Notice 2014-21 clarified the following tax concepts:

- Wages paid to employees in virtual currency are reportable as ordinary income by the employee;
- Wages paid to employees in virtual currency are subject to employment taxes by the employer;
- Virtual currency that is received in exchange for services or goods is reportable as ordinary income, and is subject to self-employment tax;
- Virtual currency is generally a capital asset in the hands of a taxpayer, and the gain or loss on the sale of virtual currency is generally treated as a capital gain. In other words, virtual currency is generally taxed as *property*, and not currency;
- Taxpayers who "mine"[6] virtual currency generally realize gross income valued as of the fair market value as of the date of receipt;
- Virtual currency is subject to information reporting; and
- Taxpayers who do not report virtual currency in a manner consistent with Notice 2014-21 may be subject to civil or criminal penalties.

In general, when taxpayer sells or disposes of a capital asset, they should include IRS Form 8949, *Sales and Other Dispositions of Capital Assets*, with their federal income tax return. Although Form 8949 is not mentioned in Notice 2014-21, taxpayers who sold or exchanged virtual currency generally should use Form 8949 to report the transaction on their federal income tax return for the year of the transaction.

While the guidance included in Notice 2014-21 was both welcome and needed, it was also woefully insufficient for the fast-moving virtual currency world. The 16 answers included in this Notice provide a starting point for reporting virtual currency transactions.

Then, on October 9, 2019, the IRS issued additional guidance. Rev. Rul. 2019-24 and the accompanying Frequently Asked questions clarified many questions but left more. Some of the most important guidance issued in October 2019 includes clarification on the following issues:

- A hard fork that does not result in receipt of new cryptocurrency is not taxable (FAQ 21);
- A hard fork followed by an "air drop" results in taxable income in the year the taxpayer receives the cryptocurrency (FAQ 22);
- Unless a taxpayer specifies otherwise, the default accounting method for determining basis in cryptocurrency is First In, First Out, or "FIFO" (FAQ 38); and
- Good record keeping is essential. A taxpayer's cost basis is often based on the value that the cryptocurrency traded for at the exact date and time received. (FAQs 24, 25, 26, 37). The price for cryptocurrency is highly volatile and can sometimes fluctuate by $1,000 or more per day. Taxpayers will need to be highly vigilant in record keeping to ensure accurate cost basis and fair market value.

While the guidance was welcome and needed, more guidance is still needed. For example, the guidance did not expressly provide that "mining" for cyrptocurrency is a trade or business, and therefore it is unclear whether and to what extent miners can claim expenses associated with mining. Many individuals are currently working on developing new forms of cryptocurrency and being compensated in the future value of that currency. The IRS's guidance on how those individuals should recognize income will almost certainly lead to future litigation:

> **Q27**. I received cryptocurrency that does not have a published value in exchange for property or services. How do I determine the cryptocurrency's fair market value?
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> **A27**. When you receive cryptocurrency in exchange for property or services, and that cryptocurrency is

not traded on any cryptocurrency exchange and does not have a published value, then the fair market value of the cryptocurrency received is equal to the fair market value of the property or services exchanged for the cryptocurrency when the transaction occurs.

IRS Virtual Currency Enforcement Efforts

The lack of guidance has not slowed down the IRS's virtual currency enforcement efforts. In 2017, the United States filed a lawsuit against Coinbase, a virtual currency exchange.[7] The IRS served a summons on Coinbase requesting certain account information. Coinbase did not comply with the summons, and the government filed a petition to enforce the summons in District Court. To support its petition, the government demonstrated the significant gap in virtual currency tax compliance. According to the evidence entered by the United States, during 2013 through 2015 Coinbase had almost six million customers, offered virtual currency trading in 33 countries, and exchanged $6 billion in Bitcoin.[8] Yet, during that same time period, the IRS had received only 800 to 900 IRS Forms 8949 reporting virtual currency transactions.[9] The District Court for the Northern District of California found this discrepancy in reporting virtual currency sufficient to enforce the summons. The Court explained:

> That only 800 to 900 taxpayers reported gains related to bitcoin in each of the relevant years and that more than 14,000 Coinbase users have either bought, sold, sent or received at least $20,000 worth of bitcoin in a given year suggests that many Coinbase users may not be reporting their gains. The IRS has a legitimate interest in investigating these taxpayers.[10]

Accordingly, Coinbase was ordered to produce to the IRS the name, taxpayer ID number, birth date, address and records of account activity for all accounts for which the equivalent of at least $20,000 was bought, sold, sent, or received during tax years 2013 through 2015.[11] Coinbase notified about 13,000 customers that pursuant to this order, their account information would be turned over to the IRS.[12]

After its Coinbase success, in July 2018, the Large Business and International Division of the Internal Revenue Service ("LB&I") announced five new compliance campaigns, including one specifically designed to address the compliance gap in reporting virtual currency transactions. The announcement explained that the "Virtual Currency Compliance campaign will address noncompliance related to the use of virtual currency through multiple treatment streams including outreach and examinations."[13]

More recently, IRS Criminal Investigation Division ("CI") Chief Donald Fort has announced that virtual currency is a high enforcement priority for CI. For example, at a March 9, 2018, Federal Bar Association Section on Taxation Conference he identified three areas of focus for virtual currency tax enforcement:

> *The need for additional guidance on the tax treatment of virtual currency is obvious, but the IRS is not waiting for such guidance to be issued before enforcing the tax laws. Instead, the IRS has made virtual currency tax enforcement a priority both in the civil and criminal divisions of the agency. Taxpayers who have virtual currency need to get real about the IRS.*

1. Reporting gains on disposition of virtual currency, or lack of reporting;
2. Use of virtual currency accounts as alternatives for other financial accounts like bank accounts to avoid detection by the IRS; and
3. Use of virtual currency in business transactions, such as paying employees wages in virtual currency without proper tax withholding or reporting.[14]

Finally, on July 26, 2019, the IRS announced that as part of the agency's larger enforcement efforts, over 10,000 taxpayers who own virtual currency will receive one of three letters regarding virtual currency reporting.[15]

Letter 6173

IRS Letter 6173 explains that the IRS received information that the recipient had one or more accounts in virtual currency and that the recipient may not have met their U.S. tax filing and reporting obligations. The letter indicates that it is being sent to taxpayers who were required to file a tax return but did not do so, taxpayers who filed tax returns that were incorrect because they did not report virtual currency transactions on their tax returns, and taxpayers who believe that their tax return is correct, but need to demonstrate to the IRS why their tax return is, in fact, correct. Finally, Letter 6173 indicates that if no response is received, the IRS may refer the account for an examination.[16]

> *Practitioners who represent clients in virtual currency cases should and will argue that the lack of guidance, and not taxpayer intent, is at fault for compliance gap in this area.*

Letter 6174

Letter 6174 explains that the IRS received information that the recipient had one or more accounts containing virtual currency and may not know what their U.S. tax obligations are with regard to the virtual currency. Unlike Letter 6173, Letter 6174 does not include descriptions of who received the letter, and instead includes guidance on how virtual currency should be reported. Recipients of Letter 6174 are urged to carefully read the guidance, review their income tax returns, and contact the IRS if their original filed tax return was incorrect. Letter 6174 clearly indicates that no response is required.[17]

Letter 6174-A

Letter 6174-A is almost identical to Letter 6174, except that it states that taxpayers who do not respond may receive additional correspondence about potential future enforcement action.[18]

Letters 6173, 6174, and 6174-A indicate that they are being sent based on information the IRS received regarding the taxpayer from a third party. The IRS press release states that 10,000 letters were sent. It is safe to assume that the information the IRS received is the account information belonging to the 13,000 Coinbase customers. The 3,000 customers whose names were turned over and did not receive a letter should not sit back and relax, nor should customers of other virtual currency exchanges. IRS Commissioner Charles Rettig stressed the importance of virtual currency account holders coming into compliance after the letters were issued when speaking at the National Association for Enrolled Agents on July 30, 2019.[19] He explained, "I'm all in on using our criminal enforcement resources to the fullest extent that we can."[20]

Next Steps for Virtual Currency Account Holders

Virtual currency account holders must take the IRS enforcement action seriously. Taken together, the *Coinbase* case, the LB&I compliance campaign, the IRS enforcement letters issued in July of 2019, and the constant reminder that virtual currency compliance is a high enforcement priority for the CI division demonstrate that the IRS is putting significant resources into ensuring that virtual currency account holders pay the tax that is due from their transactions.

Should Virtual Currency Account Holders Re-Affirm Their Returns?

IRS Letter 6173 directs taxpayers who filed tax returns and believe their tax returns were correct to sign a statement included with Letter 6173, under penalty of perjury, that the original return is correct. Taxpayers should carefully consult with an attorney before considering signing such a statement. Any declaration under penalty of perjury that is not true and correct as to every material matter may result in a felony.[21]

Should Virtual Currency Account Holders Amend Returns?

IRS Letters 6173, 6174, and 6174-A all invite taxpayers to amend their returns if they failed to report virtual currency correctly. The LB&I Compliance Campaign announcement also encourages taxpayers "with unreported virtual currency transactions … to correct their returns as soon as practical."[22] But amending a tax return that was originally filed incorrectly is a serious undertaking that should not be casually undertaken.[23] Blindly amending a tax return after the Chief of IRS CI announced that the very subject of the amendment is a high CI enforcement priority is beyond reckless. Instead, taxpayers and their advisors need to work together to develop a carefully and well-reasoned plan before submitting any amended returns to the IRS.

Taxpayers who have bought, sold, or received virtual currency but have not received IRS Letter 6173, 6174, or 6174-A should not breathe easy. Any virtual currency account holder who did not report the required information on a tax return but did not receive any of these IRS letters may not have received it for one or more of the following reasons:

- The taxpayer is not a Coinbase account holder and so is not included in this round of enforcement;
- The taxpayer is under criminal investigation and so will not receive a letter from IRS civil enforcement;
- The IRS is not done processing and sending the civil enforcement letters to all intended recipients; or
- The taxpayer moved and did not notify the IRS of the new address.

Any virtual account holders who did not receive one of these IRS letters but thinks that their past tax returns do not completely and accurately report all virtual currency transactions should immediately consult an attorney regarding the best way to move forward.

For many taxpayers who have virtual currency reporting issues, the mistake was an honest mistake. The lack of IRS guidance has no doubt contributed to the lack of correct reporting. But it cannot account for the entire gap between the tens of thousands of taxpayers who should have filed IRS Form 8949 and 800–900 who did. Taxpayers who did not make an "honest mistake" may decide the best way to resolve virtual currency issues is to participate in the IRS's Voluntary Disclosure Practice.[24]

Conclusion

Each year, the IRS sponsors an IRS Nationwide Tax Forum that provides continuing education in important tax topics. In the summer of 2019, I had the privilege of presenting *Tax Treatment of Cryptocurrency Transactions and IRS Tax Enforcement* at both the Chicago and the Orlando Tax Forums. At each Forum, after a presentation to a packed room was finished, there was a line of at least 30–40 tax practitioners who had infinite questions about how to advise their clients who are virtual currency miners, investors, and employers. Even though the IRS recently issued guidance, more is needed to address the fast-moving cryptocurrency world. Practitioners who represent clients in virtual currency cases should and will argue that the lack of guidance, and not taxpayer intent, is at fault for compliance gap in this area.

ENDNOTES

1 *Bitcoin: A Peer-to-Peer Electronic Cash System*, Satoshi Nakamoto, October 31, 2008, *https://bitcoin.org/bitcoin.pdf*. Who Satoshi Nakomoto is, whether it is one person or multiple people, remains a mystery today. For purposes of this article and determining proper tax treatment and how to approach an IRS examination connected to virtual currency, the actual creator of Bitcoin is not relevant.

2 Yahoo Finance Historical Price Index, *https://finance.yahoo.com/quote/BTC-USD/history?period1=1262325600&period2=1569214800&interval=1d&filter=history&frequency=1* (last visited Sept. 23, 2019).

3 *Id.*

4 *Id.*

5 IRS Notice 2014-21.

6 Taxpayers can earn new Bitcoin (as opposed to merely trading Bitcoin) by using vast computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger. This process is called "mining."

7 *Coinbase*, 17-cv-01431-JSC (N.D. Cal. 2017).

8 *Coinbase*, 17-cv-01431-JSC, Declaration of IRS Agent David Utzke, Docket No. 3 at ¶20.

9 *Id.*, at ¶11.

10 *Coinbase*, 17-cv-01431-JSC, 2017 WL 5890052 at *4 (Nov. 28, 2917) (Order re: Petition to Enforce IRS Summons).

11 *Id.*, at *8.

12 Coinbase IRS Notification, February 23, 2018, *https://support.coinbase.com/customer/portal/articles/2924446*.

13 IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns, July 2, 2018, *www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns*.

14 Nathan J. Richman, *IRS Official Says Virtual Currencies Are a Threat Now*, 2018 Tax Notes Today 48-11 (Mar. 12, 2018).

15 IRS News Release IR-2019-132 (July 26, 2019), *www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts*.

16 *Id.* (follow "Letter 6173 (PDF)" hyperlink); *see also www.irs.gov/pub/notices/letter_6173.pdf*.

17 *Id.* (follow "Letter 6174 (PDF)" hyperlink); *see also www.irs.gov/pub/notices/letter_6174.pdf*.

18 *Id.* (follow "Letter 6174-A (PDF)" hyperlink); *see also www.irs.gov/pub/notices/letter_6174-a.pdf*.

19 Jonathan Curry, *Rettig on Virtual Currency Letters: Take a Hint*, 2019 Tax Notes Today Fed. 148-4 (Aug. 1, 2019).

20 *Id.*

21 Code Sec. 7206.

22 IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns, *supra* note 20.

23 For an excellent discussion of the considerations to weigh when deciding whether to amend a federal income tax return, *see* Bryan Skarlatos and Stephen A. Josey, *To Amend or Not to Amend: Correcting Non-Compliance on Past Returns*, J. Tax Prac. & Proc., Feb.–Mar. 2019, at 15.

24 For a thorough and detailed description of the new Voluntary Disclosure Practice, *see* Sanford J. Boxerman, *The Past, Present and Future of the IRS's Voluntary Disclosure Practice*, J. Tax Prac. & Proc., Apr.–May 2019, at 29.