

Alert | Tax Audits, Litigation & Criminal Tax Defense



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IRS Actively Seeking Information Regarding Cryptocurrency Via John Doe Summonses

Taxpayers that have engaged in cryptocurrency transactions should be aware that the Internal Revenue Service (“IRS”) is seeking customer records from cryptocurrency exchanges.

The Department of Justice (“DOJ”) recently filed petitions in the District of Massachusetts and the Northern District of California asking to allow the IRS to serve John Doe summonses on two cryptocurrency exchanges.

A John Doe summons is an investigative tool used by the IRS to seek information about unnamed taxpayers from a third party. A John Doe summons is authorized under Internal Revenue Code Section 7609(f) and allows the IRS to obtain the names, requested information, and documents concerning all taxpayers in a certain group.

Although the two John Doe summonses are nearly identical and the DOJ made similar arguments to support both petitions, the two requests resulted in different outcomes. The federal court for the District of Massachusetts authorized the IRS to serve the John Doe summons whereas the federal court for the Northern District of California did not. Rather, the California court expressed concerns about the scope of the John Doe summons finding the request to be too broad. The court issued an order to show cause why the petition to authorize the service of the John Doe summons should not be denied, requiring the government to “specifically address why each category of information sought is narrowly tailored to the IRS’s investigative needs, including whether requests for more invasive and all-encompassing categories

of information could be deferred until after the IRS has reviewed basic account registration information and transaction histories.”

Both the John Doe summonses request information regarding U.S. taxpayers who conducted transactions in cryptocurrency totaling at least \$20,000 in any one year during the years 2016 to 2020. The documents the IRS is seeking are account registration records, Know-Your-Customer due diligence, account related correspondence, anti-money laundering exception reports, records of account activity, and records of account funding.

The government used similar language in briefs filed in support of the two petitions explaining that the IRS is concerned taxpayers are not properly reporting transactions in cryptocurrency. The customer records are expected to aid “the IRS’s ongoing investigation to determine the identity and correct federal income tax liability of U.S. persons who have conducted transactions in cryptocurrency.” The government expects that in response to the John Doe summonses, the cryptocurrency exchanges will be able to provide information about their “customers’ currency transactions, which the IRS will then be able to use in conjunction with other publicly-available information to examine whether an individual has complied with the internal revenue laws.”

Reporting Requirement for Cryptocurrency Transactions

Pursuant to IRS Notice 2014-21, 2014-16 I.R.B. 938, virtual currency, including cryptocurrency, is treated as property for federal tax purposes and the general principals applicable to transactions involving property apply to transactions involving virtual currency. A taxpayer that receives virtual currency for goods or services must include the fair market value of the virtual currency, as of the date of receipt, in his or her gross income. A taxpayer also realizes gain or loss on the sale or exchange of a virtual currency, which includes the use of virtual currency to pay for a service and the exchange of virtual currency for another virtual currency. Ordinary income from virtual currency is reported on Form 1040, U.S. Individual Income Tax Return. Sales and other exchanges of virtual currency are reported on Form 8948, Sales and Other Dispositions of Capital Assets and Schedule D of Form 1040.

Under Revenue Ruling 2019-24, receipt of a new cryptocurrency following a hard fork also results in taxable income. A hard fork occurs when a cryptocurrency on a distributed ledger undergoes a protocol change, splitting a single cryptocurrency into two: the pre-split blockchain, which continues to follow the legacy rules; and the post-split blockchain, which follows the updated rules. The IRS released a memorandum from the Office of the Chief Counsel, dated March 22, 2021, which clarifies that Bitcoin Cash received as a result of the August 1, 2017 Bitcoin hard fork is considered taxable income under Internal Revenue Code Section 61.¹ However, the income will be determined based on the fair market value of Bitcoin Cash on the date when the taxpayer obtained dominion and control over it. For example, if the taxpayer’s wallet supported Bitcoin Cash only on January 1, 2018, the income will be included in the taxpayer’s 2018 return based on the value of Bitcoin Cash on January 1, 2018 (not August 1, 2017). The memorandum was drafted in response to an individual who received Bitcoin Cash as a result of the Bitcoin hard fork; however, it cannot be used or cited as precedent.

For tax year 2020, the IRS added a question to the first page of the Form 1040 regarding virtual currency. The question asks, “At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?” On March 2, 2021, the IRS issued guidance on the new question through an FAQ, which states “If your only transactions involving virtual currency during 2020 were purchases of virtual currency with real currency, you are not required to answer yes to the Form

¹ CCA 202114020.

1040.” However, taxpayers should be aware that FAQs are not legal authority, which means that the information cannot be used to support a legal argument in a court case or for penalty relief.

Use of John Doe Summonses

John Doe summonses require the approval of a U.S. District Court and must meet the criteria contained in Section 7609(f). Under Section 7609(f), the summons must relate to the investigation of a particular person or ascertainable group or class of persons; the IRS must have a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of the internal revenue law; the information sought to be obtained must not readily be available from other sources; and the information sought is required to be “narrowly tailored” to information that pertains to the failure (or potential failure) to comply with one or more provisions of the internal revenue law. The final requirement was added to Section 7609(f) in 2019 as part of the Taxpayer First Act.

A John Doe summons was previously used by the IRS to successfully obtain client records from Coinbase, Inc. (“Coinbase”), a digital currency exchange. In November 2017, Coinbase was ordered to provide to the IRS client identifying information and transaction data for Coinbase customer accounts that had either bought sold, sent, or received at least \$20,000 worth of bitcoin, a type of cryptocurrency, in any year during the years 2013 to 2015.

The IRS has used the information from the Coinbase John Doe summons to investigate tax noncompliance. The IRS has sent letters to over 10,000 cryptocurrency owners that potentially failed to report income from cryptocurrency transactions. The IRS has also opened audits of taxpayers identified by the materials it received in response to the Coinbase John Doe summons. It is expected that the recent John Doe summonses at issue will lead to additional audits of taxpayers that engaged in cryptocurrency transactions.

Conclusion

The IRS is investigating taxpayers who have failed to properly report their cryptocurrency transactions and is working with DOJ to obtain information on a broad set of taxpayers through John Doe summonses. The failure to correctly report cryptocurrency transactions on Form 1040 could lead to dire penalties and even potential criminal prosecution. Taxpayers that have engaged in cryptocurrency transactions and are concerned about possible past noncompliance or have questions about current reporting requirements should seek legal advice.

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