IRS steps up cryptocurrency investigations

By **Michael Cohn**
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The Internal Revenue Service has been leading the charge on cryptocurrency investigations, with more on the way now that it has access to information from at least 14,000 customers of Coinbase, one of the largest virtual currency exchanges, after a protracted court battle.

Few taxpayers currently report their transactions in cryptocurrencies like bitcoin and ethereum. "Some of the press reports indicate there were some $90 billion of unreported gains in 2017," said Steven Toscher, a principal at Hochman, Salkin, Rettig, Toscher & Perez, during New York University's Tax Controversy Forum last week. "That's when we got the big spike in bitcoin-related currencies. There's not a lot of cryptocurrency transactions being reported on tax returns. I think the jury is still out."

Gary Alford, a special agent at the IRS's Criminal Investigation unit, played a key role in taking down Silk Road, an online bazaar where drugs and other illicit goods were sold, often via bitcoin.

Steven Toscher (left) of Hochman, Salkin, Rettig, Toscher & Perez; Gary Alford of the IRS Criminal Investigation; and Walter Pagano of EisnerAmper at the NYU Tax Controversy Forum
Photo: Mark McQueen

"I was involved in the Silk Road case," he said during Toscher's panel discussion. "That was an online drug market that was operating for about two years. For the most part, that was the first time bitcoin had a use. Before that, it was kind of like an experiment, and no one was using it to actually purchase things. That was the first real-world use: to purchase illegal narcotics on the internet."

Alford recalled the time in early 2013 when he was brought into the case. "I remember on that day I was wearing a suit and I was going into a meeting and I got herded into an office, which was not a good sign," he said. "That usually means they have something planned for you. And they said, 'Hey, we think you should look at this case, Silk Road.' They said, 'Have you ever heard of bitcoin?' I said no. 'Have you ever heard of Tor?' which was the anonymized internet board it was on. I said no. 'Did you hear about Silk Road?' I said no. They said, 'Good, you will be handling this case.'"

He was told he wouldn't need to wear a suit, but he was transferred to participate in an interagency task force with the FBI that focused on taking down Silk Road.

"What I learned was Silk Road was an online marketplace, but it was on Tor, which was a dark side, for lack of a better term, of the internet," he recalled. "It would anonymize not only the IP of the website, but it would anonymize the IP of the users. It would do no good to go to this site, which mostly had drugs, and use your credit card. It would be very easy for me to find out who purchased it. So bitcoin became very valuable, and during those times bitcoin and Silk Road were doing about 50 percent of the activity. The case had been going on since 2011."

Senator Chuck Schumer, D-N.Y., had brought it to the attention of the authorities at that time, but little had been done for over a year. "Up until 2013, you had FBI and law enforcement agencies all across the globe, and nothing worked, and eventually they said, 'Oh, let's try the IRS.' So they sent me," said Alford. "Strangely enough, within two weeks, I had identified the targets in our part of the investigation, and within three months, I had identified who was operating it. It took another three months to convince the other people this accountant/former auditor had figured out who was actually operating the site. We eventually took that site down in 2013, and I think this is what actually brought it to the mainstream."

He believes the publicity about the fortune changing hands on Silk Road opened the eyes of the larger public to bitcoin and its possibilities.

"Most people up until then, unless you were actually on the site looking to buy drugs on this market, you really didn't understand what bitcoin was about," said Alford. "But when we took the site down, we said it did $1.2 billion over two years and that we had seized 176,000 bitcoins. For those who are wondering, at current rates, that's over a billion dollars today."

The price of a bitcoin shot up not long after Silk Road was seized by the authorities.

"During the takedown in October 2013, bitcoin was trading at $100," said Alford. "I was joking at the time with the other investigators, we were betting do you think bitcoin will go down from here, or will it go up from here? One month after we took it down at $100 per coin, it spiked to $1,000 per coin, and interest just went through the roof."

The IRS gained early experience from the Silk Road investigation and it aggressively pushed to get information from Coinbase about its users through John Doe summonses, similar to the kind it used to go after Swiss banks like UBS. Late last year, a judge ordered the company to provide it to the IRS (see Coinbase customers could soon find themselves in IRS cross-hairs).

"We have been involved in this since 2013 so we are ahead of the curve," said Alford. "We already have collected tons of information. When we started, no one knew about bitcoin. Now we're waiting to see as more and more information comes out, we're looking to use some of that information that we've collected."

Walter Pagano, a partner, tax controversy practice leader, forensic accountant and litigation consultant at the accounting firm EisnerAmper, thinks the virtual currency issue is a significant one for the IRS and the Justice Department's Tax Division.

"Quite frankly I think it already is a threat to compliance," said Pagano, who was also on the panel. "If you have thousands and thousands of transactions, and you have thousands and thousands of individuals who are participating, many from an investment point of view, and the fact that it's on the radar of both the Service and the Justice Department, I think that there is a significant interest to the extent that there is already a threat to compliance."

He pointed out that the guidance issued by the IRS in 2014 in Notice 2014-21 said virtual currencies are considered to be property. "Therefore, it's pretty clear that assuming that description holds as a matter of law, it may get litigated at some point," said Pagano. "When you think about property, I think we all can recognize as tax practitioners that traditional tax principles should apply. When you think about some of the basic language that you deal with every day, for a sale or exchange of property, whether a transaction constitutes a like-kind exchange, these are important words that will eventually determine exactly how this issue evolves."

He and Alford noted that "willfulness" will be a key matter when it comes to proving tax evasion, implying an intentional violation of a known legal duty.

"With media attention and more interest and more commentary in the writings about bitcoin and cryptocurrency, at some point it may be very difficult for a taxpayer to argue, 'I might have been negligent, I might have even been grossly negligent, but I don't know much about this.' If there is an actual known legal duty, then perhaps the argument will go the other way," said Pagano. "There are some open questions as to the application of traditional tax principles that may or may not apply to virtual currencies."

He pointed out that taxpayers are obligated to maintain books and records that, upon request of the IRS, have to prove what's on their tax returns. That could be a problem for cryptocurrency transactions.

Toscher suggested the need for a reporting mechanism for cryptocurrency transactions. "There are a lot of cryptocurrencies," he said. "There are a lot of different exchanges out there, totally unregulated at this point, or largely, though the SEC is starting to look at those. But this is all computer-driven information. It lends itself to information reporting. Broker-dealers have to issue their 1099s, their basis information, and I think that's what Treasury and the IRS need to be looking at if this is truly going to be a significant part of the economy. You see big brokerages moving into this area, so I think we need to start looking at that."

Before the panel discussion, Richard E. Zuckerman, principal deputy assistant attorney general in the Department of Justice's Tax Division, also spoke at the NYU Tax Controversy Forum on Friday. "We're very interested, like the Service is, in cryptocurrency," he said. "That is the accounting abuse du jour. We have specific lawyers in the Tax Division that are experts in cryptocurrency, whatever that means at this juncture."

He noted that to prove a case, prosecutors need to be able to identify the transactions for a specific taxpayer and it helps to have outside information to do that, such as it now has from Coinbase. The DOJ tax lawyers who specialize in cryptocurrency are in the process of going around the country training with the IRS and various U.S. Attorney offices.

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