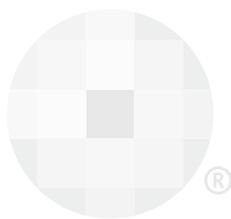


# The Future of Virtual Currency Tax Prosecutions—A Matter of When, Not If

By Sandra R. Brown\*

*Sandra R. Brown examines virtual currency and the challenges facing taxpayers, tax professions and the IRS.*

## Got Bitcoin or Other Virtual Currency?



The explosion of virtual currency has created challenging tax reporting issues for taxpayers and tax professionals alike. But does this uncertainty mean the federal government will shy away from prosecuting criminal tax cases involving the failure to report virtual currency? The odds-on favorite answer is simply: no.

To that point, the IRS has signaled two important things with respect to virtual currency and tax enforcement. First, the IRS has made it a priority to go after “data” in its enforcement of the tax laws with respect to taxpayer’s obligations to accurately report financial transactions, including transactions involving virtual currency. Second, the IRS Criminal Investigation (“IRS CI”) has already taken steps to put together a unit of cybercrime special agents with the skill set and tools to investigate virtual currency tax crimes.

In other words, IRS CI not only has the *motive* but also the *means* to investigate taxpayers who willfully violate the tax laws through the use of virtual currency.

## What Is Virtual Currency?<sup>1</sup>

In very simplistic terms, virtual currency is a type of unregulated digital currency that is only available in electronic form and not in a physical form. It is stored and transacted only through designated software, mobile or computer application, or through dedicated digital wallets. The transactions occur over the Internet or over secure dedicated networks.

Virtual currencies use decentralized control as opposed to centralized electronic money and central banking systems, based on “blockchain” technology. A blockchain is a continuously growing list of records, called blocks, which are linked and secured using cryptography. Each block typically contains a cryptographic hash of the previous block, a timestamp and transaction data. By design, a blockchain is inherently resistant to modifications of the data.

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Virtual currency is not real currency. Unlike real currency, virtual currency lacks legal tender status and is not within the control of any jurisdiction or sovereign. As a result, the value of virtual currency can be, and has been, as the market has shown over the past few years, volatile. If it is so volatile, why would anyone deal with virtual currency?

Some of the benefits of virtual currency are: (1) there is no bank, credit card processor, or other middleman to take a cut of the payment; (2) transactions are verified and authenticated before money is transferred; (3) users of virtual currency do not need access to special hardware, payment cards, or other single-purpose devices; and (4) user's identities are, in large part, protected in the process of sending and receiving cryptocurrency. Alas, it is this last point, *e.g.*, anonymity, a close cousin to concealment, which predictably raises the proverbial eyebrow of the IRS. Similar to the "badges of fraud" posed by the act of structuring cash transactions to avoid reporting disclosures to the IRS, the very nature of virtual currency's lack of transparency will place such individuals, who thereafter chose to fail to make necessary and complete disclosures, squarely in the crosshairs of the IRS's long history of viewing such behavior to be an indicia of fraud ~ worthy of a criminal tax investigation.<sup>2</sup>

## Virtual Currency Is a Focus of the IRS Criminal Investigation Division

As a direct result of its extensive work in recent years investigating identity-theft cases, which more often than not were perpetrated by cybercriminals, the IRS CI has not only gained expertise in tracking cryptocurrency and cybercrimes, it has gained an awareness of, and an appreciation for, the need to get ahead of the next wave of tax cheats.<sup>3</sup>

IRS CI has identified cryptocurrencies as an immediate tax administration concern. Don Fort, the Chief of IRS CI, has issued public warnings that IRS CI has put together a team of elite criminal agents assigned to investigate tax cases involving virtual currency being used to commit tax crimes. Mr. Fort has also made it clear, both to IRS CI and the public, that a top law enforcement priority of the tax agency is, and will be for some time in the future, going after those who use virtual currencies to evade the payment of taxes.<sup>4</sup>

Further, recognizing that virtual currency flows internationally as well as domestically and looking to develop high-impact cases, Mr. Fort announced recently that IRS

CI has formed the Joint Chiefs of Global Tax Enforcement ("J5 Alliance") consisting of tax authorities in the United States, United Kingdom, Canada, Australia and the Netherlands. One of the J5 Alliances' key priorities is focusing on virtual currency, which based upon estimates, places cryptocurrency-related tax liabilities for 2017 at \$25 billion in the U.S. alone.<sup>5</sup>

## Virtual Currency as a Criminal Tax Case

With a cadre of elite IRS CI Special Agents with the technical knowhow, key international alliances, and the backing of their top cop, all focused on going after the bad guys and gals intent on engaging in criminal tax fraud involving virtual currency, it appears that veil of secrecy that beckons many users of virtual currency may be ripped away in a repeat of the crumbling of the walls of secrecy that previously surrounded the Swiss banking world. Thus, allowing IRS CI to not only do what it does best, *e.g.*, "follow the money," but also trace it back to its taxable owner.

Dispensing of such modes of secrecy and concealment places the targets of these criminal tax investigations back into the familiar world of traditional criminal tax cases. A criminal tax world which requires IRS CI to not just identify the "who done it" but more importantly, the "was it a certain, taxable event" and "was it done willfully." These questions involve not only legal issues, but also the necessary gathering of facts, specifically facts involving one's state of mind. Generally, the most difficult question in a criminal tax case is proving the target's state of mind. In the world of virtual currency, however, attempts to answer the first question, *e.g.*, what are the legal tax consequences of a virtual currency transaction, may not be so simple.

While the IRS issued Notice 2014-21, setting forth its view that virtual currency, under U.S. tax laws, is to be treated as property, we currently have no statutory or regulatory tax authority on this issue.<sup>6</sup> Even presuming the Courts will uniformly accept the IRS's view in these tax cases, the tax implications of like-kind exchange considerations to virtual currency transactions occurring prior to January 1, 2018, when the limitations on Code Sec. 1031 became effective under the Tax Cuts and Jobs Act ("TCJA"), will undoubtedly raise additional legal questions for tax computations.<sup>7</sup> Tax computations are, of course, a significant aspect, if not an absolute necessity of proof,<sup>8</sup> in every criminal tax prosecution.

The lack of clarity here is further compounded by the different views of virtual currency pronounced by other federal

law enforcement agencies such as the U.S. Securities and Exchange Commission (“SEC”), the Commodity Futures Trading Commission (“CFTC”) and the Financial Crimes Enforcement Network (“FinCen”). *Is virtual currency a “security,” a “commodity,” “property,” “money,” or, perhaps, all of the above?*<sup>9</sup>

These questions mean IRS CI will not be dealing with the type of legal clarity normally found in criminal tax cases selected for prosecution. Further, this lack of clarity will most likely give rise to a multitude of pre-trial motions, in the context of *Dahlstrom*, seeking dismissal of any criminal tax case involving the reporting, or lack thereof, of virtual currency.<sup>10</sup>

The uncertain treatment of virtual currency is likely to also impact the strength of the evidence, such as the type of evidence which typically falls within what is described as “badges of fraud” which is conventionally presented to support the one element that must be proven beyond a reasonable doubt in almost every criminal tax case, e.g., willfulness. As we clearly learned from *Cheek*, there is no willful violation of the tax law if someone actually believes in good faith that he or she is not violating it, even if that belief is based on an unreasonable misunderstanding of

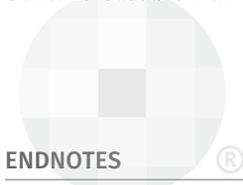
the law.<sup>11</sup> In the case of virtual currency, the hurdle to proving willfulness may actually be the need to overcome a “reasonable” misunderstanding of the law. Which means, very simply, that what we should expect to see in criminal tax cases involving virtual currency is evidence that establishes, in the oft-repeated words of former Chief of IRS CI Nancy Jardini, that criminal tax cases really are “all about the lies.”<sup>12</sup>

## Conclusion

There is no question that criminal tax prosecutions of virtual currency will have its unique challenges. Attributing digital transactions in a world based on cryptography can be difficult. But let us not forget that virtual currency leaves an indelible digital footprint and once the code is cracked, the information is all there.

It is worth remembering, whether looking down a dark alley or into the dark web, IRS CI is and always has been renowned for its ability to “follow the money.”

As IRS CI marks its 100th anniversary this year, we can likely expect to also finding them following the “digital money.”



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## ENDNOTES

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<sup>1</sup> See [https://en.wikipedia.org/wiki/Virtual\\_currency](https://en.wikipedia.org/wiki/Virtual_currency).

<sup>2</sup> IRM 25.1.2.3 (Sep. 6, 2015).

<sup>3</sup> See [www.bloomberg.com/news/articles/2018-02-08/irs-cops-scouring-crypto-accounts-to-build-tax-evasion-cases](http://www.bloomberg.com/news/articles/2018-02-08/irs-cops-scouring-crypto-accounts-to-build-tax-evasion-cases).

<sup>4</sup> See [www.irs.gov/pub/irs-utl/2018\\_irs\\_criminal\\_investigation\\_annual\\_report.pdf](http://www.irs.gov/pub/irs-utl/2018_irs_criminal_investigation_annual_report.pdf).

<sup>5</sup> See [www.irs.gov/pub/irs-utl/j5-media-release-7-2-18.pdf](http://www.irs.gov/pub/irs-utl/j5-media-release-7-2-18.pdf).

<sup>6</sup> IRS Notice 2014-21, 2014-16 IRB 938 (Mar. 25, 2014).

<sup>7</sup> Code Sec. 1031.

<sup>8</sup> Proof of a tax deficiency is a required element of a charge filed under Code Sec. 7201.

<sup>9</sup> See <https://cointelegraph.com/news/sec-ftc-irs-and-others-a-guide-to-us-regulating-bodies>.

<sup>10</sup> *K.L. Dahlstrom*, CA-9, 83-2 USTC ¶9557, 713 F2d 1423, cert. denied, 466 US 980, 104 S.Ct 2363, 80 LEd 2d 835 (1984).

<sup>11</sup> *J.L. Cheek*, S.Ct., 91-1 USTC ¶150,012, 498 US 192, 111 S.Ct 604, 112 LEd 2d 617 (1991).

<sup>12</sup> See [www.taxlitigator.com/wp-content/uploads/2016/02/Options\\_Arent\\_Looking\\_as\\_Good.pdf](http://www.taxlitigator.com/wp-content/uploads/2016/02/Options_Arent_Looking_as_Good.pdf).

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