NEWS ANALYSIS

A New Era for Crypto Enforcement

by Marie Sapirie

The IRS has spent over a decade using and refining a model for bringing into compliance those taxpayers who made mistakes in good faith or through non-willful ignorance, and for punishing bad actors. The renewed push to target cryptocurrency builds on its predecessor, offshore bank accounts, but is distinguishable in important ways. The IRS appears sensitive to the differences, but has more to learn, particularly about the types of taxpayers involved.

The multifaceted effort developed for offshore account compliance and enforcement includes educational outreach to taxpayers and practitioners, criminal investigations, revised tax forms, new guidance, and plans for information reporting, and the IRS is using all those aspects of the prior campaign for cryptocurrency. The lessons from the offshore accounts campaign have obviously influenced the IRS's approach, which is noticeably less one-size-fits-all than its predecessor at the same point in its evolution.

While the compliance and enforcement campaigns for offshore accounts and cryptocurrency transactions have many similarities, they aren't equivalent. Offshore accounts were nothing new when, in 2008, the John Doe summons was issued to UBS. The IRS had known for a long time that U.S. taxpayers held unreported foreign accounts. The problem was in getting information on them. In contrast, Bitcoin's source code was released in 2009. While the National Security Agency's Office of Information Security Research and Technology identified the potential for cryptocurrency to be used for tax evasion in a 1996 report, cryptocurrency tax evasion problems are more recent. One element that is common to both is the need for taxpayer education, especially for individuals who weren't trying to evade tax, but simply were unaware of their filing obligations.

The scale of the government's near-term efforts may not end up being as large for cryptocurrency issues as it was for the offshore accounts campaign, but there may be some parity between the numbers of taxpayers who own cryptocurrency and who held offshore accounts. One estimate puts the number of American adults who own cryptocurrency at 8 percent, which is roughly 19 million people. The number of taxpayers with cryptocurrency issues is far from clear at this point. In 2016 the State Department estimated that 9 million U.S. citizens lived abroad, but U.S. citizens who are resident in the United States sometimes have foreign bank accounts, too. In 2018 the IRS reported that 56,000 taxpayers entered the offshore voluntary disclosure programs that it had offered since 2009. But many more taxpayers simply filed amended returns.

The type of taxpayer who had an offshore account likely differs from the type who engages in cryptocurrency transactions. The tax-evading clients of Swiss banks believed that the IRS wouldn't find them because of the nearly impenetrable bank secrecy laws, but didn't generally hide their money offshore for ideological reasons.

In contrast, cryptocurrency owners use a medium built on open-source software, and a subset is ideologically motivated to replace fiat currencies. "I think the government should realize that it's not the same population," said Dashiell C. Shapiro of Shartsis Friese LLP, adding that although the educational approach will work for many crypto investors, unlike in the offshore area, it won't always be a matter of convincing taxpayers that they'll pay more if they don't come forward.

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It's unsurprising that the government is looking to the multifaceted offshore accounts campaign as a roadmap for increasing cryptocurrency tax compliance. The offshore compliance efforts were wildly successful for the government, despite some bumps in the road. The voluntary disclosure programs ran into several big snags for non-willful violations and unforeseen thorny technical issues regarding retirement accounts and passive foreign investment companies, but those were dealt with. (Prior analysis: *Tax Notes*, Oct. 5, 2015, p. 12.)

A Familiar Start

The Coinbase Inc. John Doe summons was reminiscent of the UBS John Doe summons. In *United States v. Coinbase Inc.*, No. 3:17-cv-01431 (N.D. Cal. 2017), the IRS obtained the district court's blessing to force Coinbase Inc. to hand over information on 13,000 customers. The IRS also released Notice 2014-21, 2014-16 IRB 938, which explained that for federal tax purposes, virtual currency is treated as property and the principles applicable to property transactions would apply to cryptocurrency transactions.

The IRS continued its publicity and educational campaign in July 2019 with "soft letters," which were sent to 10,000 taxpayers by the end of August and were intended to help taxpayers understand their filing obligations and learn how to correct mistakes. More letters are likely to go out. (Prior coverage: *Tax Notes Federal*, Oct. 28, 2019, p. 652.)

Jeffrey Neiman of Marcus Neiman & Rashbaum LLP said the IRS's publicity campaign on cryptocurrency is smart, but that cryptocurrency poses a novel challenge to law enforcement and guidance development because it forces the agency to get ahead of the technological changes, something that has historically challenged the IRS. He said further guidance on cryptocurrencies is important because the IRS and Justice Department can't enforce ambiguous rules.

Neiman noted that there's a difference between using the cryptocurrency transactions as evidence that bad actors had the required intent to commit crimes and considering transactions in which an average American thought cryptocurrency was cool and decided to buy some but didn't understand the tax implications. The latter situation will require more clarity in the law before the IRS can start enforcement, he said, adding, "They're fortunate to have good people there who understand this."

The IRS's educational efforts may end up following a somewhat different path than those for offshore accounts, because of the differences in taxpayers who hold cryptocurrencies and those who had offshore accounts. Shapiro said they're similar in that there's a mix of taxpayers who willfully aren't reporting and those who simply don't know what their obligations are, and the IRS for the most part doesn't know who's who yet. He said the IRS is taking the correct approach in giving taxpayers notice regarding their obligations through direct channels like the letters to customers and through standard media and social media announcements. That model means the IRS will eventually be better able to establish that taxpayers who still aren't in compliance were intentionally avoiding their obligations.

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Steven Toscher of Hochman Salkin Toscher Perez PC said that while the IRS didn't seem to recognize the different demographic groups involved at the start of the offshore compliance campaign and had trouble distinguishing between taxpayers who were willfully evading tax and those who were unaware of their tax obligations, it doesn't seem to be making the same mistake with cryptocurrency. He said the soft letter campaign for the latter shows a good, data-driven approach to distinguishing different groups of taxpayers.

Voluntary Disclosures

A crypto-specific voluntary disclosure program is unlikely, and that's probably wise from an IRS resources perspective. Practitioners said the guidelines of the standard voluntary disclosure program are sufficient because they offer a way for taxpayers to clean up problems. "The revised voluntary disclosure program clearly gives the pathway, and asking the question [about cryptocurrency transactions] on the tax return will make taxpayers aware," Neiman said. Once taxpayers know they have a responsibility to include cryptocurrency transactions on their returns, when they violate that responsibility, they are subject to possible criminal sanctions, he noted.

Toscher said IRS officials have emphasized that the voluntary disclosure program introduced in November 2018 targets taxpayers who need protection from criminal investigation. "For the right cases, the program is very suitable for crypto," he said, adding that to manage the IRS's resources, it may be better to avoid a special program. But for practitioners, determining who needs protection from criminal charges can be difficult, especially for taxpayers who fall into the middle area between clear criminal conduct and unintentional missteps, he said. Through the soft letter campaign, "they're giving taxpayers the opportunity to respond and take action," Toscher said. For those who do come forward and amend their returns, it would be counterproductive for the IRS to assert substantial understatement penalties, he added.

The Pattern of Future Guidance

Technical obstacles popped up as the offshore accounts campaign was rolled out — how to deal with PFICs and Canadian registered retirement savings plans, for example — and the IRS must confront similar technical issues in the cryptocurrency area. Its recent guidance on the tax treatment of hard forks in Rev. Rul. 2019-24, 2019-44 IRB 1004, is one example of tackling technical problems as they become apparent, and it seems probable that this is how the guidance will largely develop.

The future will hold plenty of challenges for the IRS as decentralized financial platforms gain more traction among users. Shapiro said that staking, which is similar to interest, and decentralized exchanges will likely present significant issues in the future. Cryptocurrency companies' ability to create a lending platform and offer derivatives is also likely to pose challenges for regulators, he said. "People are making interesting things, but they're not widely used yet," he noted. However, Shapiro added that those issues are coming sooner than people realize.

Although there will be challenges in coping with new financial instruments and structures, the IRS may not end up issuing much additional guidance regarding cryptocurrencies, absent clear direction from Congress. At least part of the point of adopting the property paradigm was to give the IRS a reprieve from trying to draft technology-specific guidance. The IRS has played the game of trying to keep up with the pace of technological change. It doesn't usually win. Finding a serviceable analogy and applying existing principles is probably the most suitable approach.

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"I'm not in agreement with the complaint about the lack of guidance," Toscher said. "Good tax lawyers can make decisions based on the historical principles of property law," he said, adding that Notice 2014-21 was fairly helpful and that the subsequent five years of analysis by the tax bar has helped align the new digital world with the principles created for a brick-and-mortar economy.

Other Avenues

Information reporting is the next cryptocurrency guidance project the IRS is working on, said Michael J. Desmond, IRS chief counsel. (Prior coverage: *Tax Notes Federal*, Oct. 21, 2019, p. 487.) He indicated that while officials believe the IRS can require some type of reporting, they must be satisfied with the scope of that authority before implementation. In a June 2018 article published in the *Stanford Journal of Blockchain Law & Policy*, Shapiro explained that the IRS needs "a 'feedback loop' of information reporting regarding blockchain transactions, as it developed through its Swiss Bank enforcement efforts," in order to make significant headway on enforcement in this area. The IRS announced a section 6045 gross proceeds reporting project in its October 8 release of the priority guidance plan. Information reporting is clearly critical to the IRS's success, and more of it is probably coming soon.

The prospects for legislation on cryptocurrency taxation seem slim right now. Unlike with offshore accounts, there's not a figure like former Sen. Carl Levin who is putting a legislative effort in motion. However, Congress appears somewhat interested in regulating cryptocurrencies, as was evident at the House Financial Services Committee's October 23

hearing on Facebook's impact on the financial services sector. Rep. Brad Sherman, D-Calif., raised concerns about cryptocurrency advancing tax evasion, as well as the illegal drug trade and terrorism. Rep. Ed Perlmutter, D-Colo., told Mark Zuckerberg that Congress needed to understand Facebook's cryptocurrency, Libra, and that "we have to regulate this."

One possible executive branch response could be a crypto task force that would coordinate regulatory policies and actions. "It would be good if crypto and financial product innovation could take place in the United States rather than abroad, and I think it would be good for there to be more coordination," Shapiro said. If the United States took the lead, the government could help encourage the creation of a safe financial environment through clear regulations that allow innovation to flourish, he added.

Cryptocurrencies pose special challenges that didn't exist for offshore accounts, but the IRS seems to have recognized the differences in applying the education and enforcement model that it refined over the past decade in the offshore space. Although technological challenges remain, the IRS has shown itself to be reasonably adept at using data and technology in its enforcement efforts. ■