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Are Bitcoin Tax Records Ever Optional With IRS? Expert Blog

EXPERT TAKE

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Cryptocurrency may be a new topic for the IRS and taxpayers to tackle but tax records are certainly not a new issue. Since the dawn of the income tax, some taxpayers have struggled with this, and the IRS knows it. At tax time, many taxpayers find themselves scrambling for receipts, looking in file folders and drawers.

These days, much of the looking is in computer files and with online services that you hope will still have the records you need. In fact, with large numbers of people placing increasing reliance on cloud services and similar types of records, the records problem today can actually be acuter than it was decades ago. There is much talk today about IRS investigations, enforcement and audits.

Yet when you come right down to it, our income tax system is largely one of self-assessment. We mostly do our own reporting, starting with self-reporting on our own tax returns. That is where it all begins, and to self-report, you need records. Besides, you need to be able to back up what you put on your tax return if you are asked.

Remember, you sign tax returns under penalties of perjury. Do not make up the numbers and do not estimate, except as a very last resort. In general, receipts and proof in tax matters are critical. In fact, the Internal Revenue Code and the Treasury Regulations are full of substantiation requirements. Receipts, invoices and canceled checks count big time.

If you are ever audited and you need to account for any capital gain, especially long-term where the tax rate is reduced, you may have to show documentation to prove your position. You need to be able to prove any tax basis you claim. You need to be able to prove your holding period too.

Keep a record

The burden is always on you to keep documentation and perform recordkeeping. What if an exchange you are using suddenly goes out of business and disappears? You may suddenly not be able to get your records. That could mean not being able to establish your basis or your holding period.

That is one reason having a backup system of your own can make sense. However, you can keep it straight, try to keep good records of all your trading and investment activity. That is true with cryptocurrency or any other investment assets.

Downloading and exporting transaction details or copying it all down however works for you. Since purchases made with cryptocurrency are dispositions, keep a record of dates, amounts and details of those dispositions too. What happens though if there are holes in your records?

But if not...

It isn’t clear whether the IRS will apply different standards to cryptocurrency records. However, the substantiation requirements are likely to be similar in this context to others. Fortunately, there are some positive historical cases in which taxpayers have won tax cases even though their records were downright lousy.

That is, sometimes, the lack of a receipt may not prevent you from claiming a deduction or even prevailing in court if you end up in a fight with the IRS. In fact, if you can't find your records or receipts, it is worth remembering the so-called Cohan Rule. This tax rule had its genesis in Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

George M. Cohan was an early Broadway pioneer, authoring such hits as "Give My Regards to Broadway" and "Yankee Doodle Boy." Cohan had a big appetite, and he spent money in a big way. His statue still stands in New York's Times Square. But the IRS disallowed many of Cohan's show business travel and entertainment expenses for lack of receipts.

You see, Cohan often paid cash, it seems and sometimes took dozens of people out for dinner. The IRS demanded receipts for proof, and Cohan didn't like being effectively called a liar. He also didn't like losing out on tax deductions. So, he took the IRS to the Board of Tax Appeals, the precursor to today's US Tax Court.

It upheld the IRS, receipts being the stock in trade of a tax system. However, Cohan would not give up and appealed to the Second Circuit Court of Appeals. There, the IRS thought it had a rock solid case, arguing for requiring rigidity in tax records. However, the Second Circuit rocked the IRS back on its heels by announcing what would come to be known as the Cohan Rule.

To this very day, it serves as an exception to stringent IRS recordkeeping requirements. It allows taxpayers to prove by "other credible evidence" that they actually incurred the expenses for deductible purposes. That means testimony can itself be enough, even if you have no receipts.

Cohan rule

Will the Cohan Rule help and already suspicious IRS when it comes to Bitcoin or other digital currency? It is hard to say, but it would be a big mistake to think that you don't require receipts. You should never consider the Cohan Rule as a get-out-of-jail-free card when it comes to taxes or tax records.

In fact, the IRS still is lukewarm on this rule nearly 90 years after the case was decided. The IRS doesn't like it, and the Cohan Rule doesn't always work in court. The Cohan Rule has most classically been applied to travel and entertainment expenses.

However, it could apply to virtually any item not specifically subject to heightened substantiation requirements under the Tax Code or Treasury Regulations. There are special substantiation rules for certain travel and meal expenses, passenger automobiles, computers and cell phones. In those cases, the Cohan Rule can't apply.

The Cohan Rule does not permit a complete absence of substantiation. Rather it allows a different kind of substantiation. If you can convince the IRS by oral or written statements or other supporting evidence and can give a reasonable approximation of the expense, you may be entitled to the deduction despite your lack of documentation.

The Tax Court has applied the Cohan Rule to allow deductions for expenses for items such as education expenses, a beauty consultant's license fee, gambling losses, qualified research activities, the building and placement of signs, and a whole host of other expenses. Travel and entertainment expenses, however, are perhaps the most classic ones. Even charitable contributions have occasionally been allowed under the Cohan Rule.

However, you can't use the Cohan Rule where there are special strict substantiation requirements, as there are for some charitable contributions. Those rules require you to have a receipt even for small cash donations, including $20 put in the collection plate on Sunday and, for donations of more than $250, a contemporaneous written acknowledgment from the charity before filing your tax return.

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