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Crypto Tax Reporting Failures Can Be Expensive, Even Criminal

The Internal Revenue Service is aware that millions of cryptocurrency transactions may still remain unreported. Taxpayers may think they will not be caught, and many Coinbase users may have thought their information would be protected until the John Doe summons proved otherwise. The best way to avoid penalties is to disclose and report as accurately as you can, showing that you did not have a willful intent to avoid taxes.

Otherwise you could face large penalties and even potential criminal investigation. Anyone convicted of tax evasion, for example, may face up to five years in prison and a fine that could be as high as $250,000. Taxpayers may think that the IRS could penalize them but might assume that they do not need to worry about any criminal implications.

Recent moves by the IRS

However, taxpayers should consider recent actions by the IRS regarding criminal referrals. IRS Commissioner Charles Rettig has taken actions that indicate a potential increase in the number of criminal investigations. Eric Hylton from the IRS Criminal Investigation Division was recently asked to head the Small Business/Self-Employed Division of the Internal Revenue Service. Commissioner Rettig has stated that the current percentage of civil referrals included in the criminal investigation inventory is unacceptable.

The IRS is also clearly taking steps to build cases against taxpayers who fail to report cryptocurrency. The IRS soft letters mentioned above, if received and ignored, can provide evidence of an intentional effort to hide assets instead of an innocent mistake or misunderstanding. The IRS recently released a draft 2019 Form 1040 containing a question targeting cryptocurrency. A checkbox on Schedule 1 requires taxpayers to answer whether at any time during 2019 they sold, sent, exchanged or otherwise acquired any financial interest in cryptocurrency.

The Department of Justice Tax Division has successfully argued that failure to check a box, in the context of reporting foreign bank accounts, is per-se willfulness. Willful failures, as opposed to non-willful actions, carry higher penalties and a greater threat of criminal investigation. The Department of Justice Tax Division is working with the IRS, is already involved in several criminal prosecutions involving cryptocurrency and warns that others are coming. The IRS Criminal Investigation Division is also meeting with tax authorities from other countries to share data and enforcement strategies to find potential cryptocurrency tax evasion.

How is cryptocurrency treated?

The IRS's guidance from 2014 (Notice 2014-21) states that cryptocurrency is not currency for tax purposes, and rather that it is property. Since cryptocurrency is treated as property (e.g., stocks or real estate), taxpayers pay taxes if they realize a gain but may also be able to claim losses when they are realized. As property, taxpayers must know when they bought the cryptocurrency, how much they paid and what they received for it.

For stocks and real estate, this may be simple. For cryptocurrency, it can be much more difficult. The IRS's FAQs state that all income, gain or loss involving virtual currency must be reported regardless of the amount or if you received a Form W-2 or 1099. Many cryptocurrency investors have made purchases at multiple times and for many years.

The IRS guidance indicates that basis is determined by the fair market value of the virtual currency, in U.S. dollars, when the virtual currency is received. If the virtual currency was received from an established exchange, the value may be easily determined. However, if the taxpayer received the virtual currency through peer-to-peer transactions, or if the cryptocurrency itself does not have a published value, it can be considerably messier. The IRS still requires taxpayers to use some reasonable method to value the cryptocurrency and to establish that such value is accurate.

How taxpayers should handle cryptocurrency

There are various websites available that may offer help in figuring out a taxpayer's transaction history. Some of them will even attempt to estimate amounts owed and fill out the Schedule D form for reporting gains and losses. These software programs may not be perfect, and the IRS may be unforgiving for mistakes. However, there is at least one reported case (not involving cryptocurrency) providing support for relief from penalties if the software used is to blame for the mistake.

Cryptocurrency investors who mine cryptocurrency may have other issues. For one, they may have trouble deciphering exactly when they received the mined cryptocurrency for purposes of determining its value for reporting purposes. The IRS guidance says that taxpayers must use a reasonable method to determine the fair market value used to determine gain or loss.

Taxpayers can use a "first in, first out" method or some other method so long as it is consistently applied. If taxpayers have not kept a detailed log in the past, then some method will need to be used for past transactions. Ideally, it will support an argument of best efforts to comply in the past and help support consistent reporting efforts going forward.

As cryptocurrencies become more common in the marketplace, they can be used to purchase items or services. However, because cryptocurrency is treated as property, every exchange can trigger a gain or loss. Taxpayers using cryptocurrency for small purchases could have multiple small reportable gains and losses that must be recorded, reported and accounted for over the course of the year.

Remaining uncertainties of cryptocurrency reporting

More generally, of course, even with the IRS's recent guidance, significant questions remain. The recent guidance and FAQs do not address specifically how to compute value, how to determine basis or how estate tax rules apply to cryptocurrency. Of course, FAQs are not technically a legal authority on which taxpayers can rely. For these, and many other issues, taxpayers are still guessing — and hoping that making some effort to properly report will help them avoid penalties if they are audited.

Even so, the new guidance thankfully does include Revenue Ruling 2019-24, in addition to the expanded FAQs. This new revenue ruling addresses common questions by taxpayers and tax practitioners regarding the tax treatment of cryptocurrency hard forks and air drops. The IRS has specifically requested public comments to the recent guidance, providing at least one avenue for input by the taxpaying public. For the time being, the safest course appears to be careful reporting, with amending and reporting for the past as needed. In some cases, normal amended returns or quiet disclosures may be fine.

In other cases, formal voluntary disclosures to the IRS may be appropriate. In either circumstance, it seems wise to use one's best efforts with the current guidance, remaining open to the possibility that one may want to make adjustments later if new guidance is issued. The world isn't perfect, and the IRS's response to cryptocurrencies over the past five years has not been either. But there can be no mistaking the IRS's intent to make big enforcement and revenue drives into this brave new world.

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