Forbes

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THE TAX LAWYER

TAXES 1/03/2017

IRS Escalates Hunt For Bitcoin Users In Coinbase Summons Case

The Internal Revenue Service is fighting to obtain vast amounts of data on Bitcoin and other digital currency transactions. But what the IRS will get–and when–remains unclear. In November, a federal court authorized the IRS to serve a John Doe Summons on Coinbase, Inc., a digital currency transaction hub. The IRS wants information on the site's users and their transactions. But some Coinbase users, led by Mr. Jeffrey K. Berns, then moved to intervene in the IRS's case to enforce the summons. Their argument is that the IRS request was not properly calibrated and threatened their privacy.

Now, however, the IRS has pushed back against this motion to intervene. The IRS has argued in court filings that Mr. Berns should not be allowed to intervene, because the IRS no longer needs his information from Coinbase. The IRS points out that Mr. Berns has already identified himself in court as a user of Coinbase, so he can hardly object that his privacy is threatened. The theory of a John Doe Summons, after all, as that the IRS does not have taxpayer identities. It is worth remembering that the IRS used a John Doe Summons to get names of Swiss bank account holders from UBS. That turned out well for the IRS, with collections now topping $10 billion. The IRS is pursuing Coinbase in the same way.


(Photographer: Chris Ratcliffe/Bloomberg)

The IRS's theory is that since Mr. Berns is no longer a target of the summons, he does not have standing to intervene on behalf of other Coinbase users. However, as Mr. Berns pointed out in an interview to Coindesk, the IRS summons asked for much more than just the customers names. The IRS wanted transaction data too, presumably in order to find out who has failed to pay taxes on their digital currency gains.

On January 3, 2017, Mr. Berns filed a reply to the IRS's argument that Mr. Berns' motion is moot because the IRS withdrew the summons as to Mr. Berns only, even though it has not obtained any of the documents or information sought by the summons with respect to Mr. Berns. Mr. Berns also argues that the John Doe summons statute does not allow the IRS to shield itself from inquiries into whether it has acted in good faith. The motion is currently scheduled to be heard on January 19, 2017.

But even if Coinbase customers are allowed to intervene in the case and have a chance to add their voices to Coinbase's, the odds favor the IRS getting the information in the end. Courts generally give the IRS wide latitude to request information that could be relevant to tax investigations. The IRS wins the vast majority of summons enforcement cases. A decent outcome for Coinbase and its customers might be that the summons will be limited or modified in some way, either by the court, or by the parties in a settlement.

But any success by the IRS on its summons could put some users of digital currency in the IRS cross hairs. Matching up transactions and tax returns is not that hard. Taxpayers who have hidden income from Bitcoin and other digital currency sales could face taxes, and potentially big civil penalties. Some cases could even end up as criminal tax cases with the possibility of imprisonment. Given the stakes, taxpayers who have a compliance mismatch should get some advice about making corrective tax filings. The IRS is generally considerably more forgiving if a taxpayer makes corrective filings before being caught or audited.

Even so, some Coinbase customers will wait and see if the IRS actually gets the Coinbase records. As tempting as that may be, however, a fix after the IRS has the records is unlikely to look as pristine. Those that wait to fix their filings and come into compliance later are likely going to face the harshest penalties when the government eventually finds them. Of course, some digital currency users have been reporting their digital currency transactions on their tax returns. Even so, they might not have been reporting them *correctly*.

Remember, the IRS treats Bitcoin and other digital currencies as property, not currency. That means sales could give rise to capital gain, rather than ordinary income. And the tax code limits the amount of capital losses that can be carried forward annually to $3,000. Bitcoin prices have swung wildly, so some taxpayers with significant losses may not be able to use those losses. As the legal fight over Coinbase account records heats up, taxpayers who have been reporting Bitcoin transaction–and especially those who have not–should be watching.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.