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IRS Hunt for Cryptocurrency Isn't Going Away: Expert Blog

EXPERT BLOG

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Are Bitcoin and other cryptocurrencies still in the IRS crosshairs? Bitcoin users are surely the most at risk from a tax compliance viewpoint. However, it's clear that other digital currencies may not be far behind. In IRS Notice 2014-21, the IRS announced that Bitcoin and other digital currency is actually *property* for tax purposes, not currency. That in itself has some big tax consequences.

Just consider these situations. Wages paid to employees using virtual currency are taxable, must be reported on a Form W-2, and are subject to federal income tax withholding and payroll taxes. If you pay someone in property, how do you withhold taxes?

You have to send the IRS money from something else. You either pay the employee some cash and some Bitcoin, and withhold extra on the cash. Or, you sell some of the Bitcoin to get dollars to pay the IRS.

How about payments using virtual currency made to independent contractors? They are taxable too, and payers engaged in a business must issue IRS Forms 1099. You can't enter "1,000 Bitcoin" on Forms 1099, either. You must value the payment in dollars, as of the time of payment. A payment made using virtual currency is subject to Form 1099 reporting just like any other payment made in property. Forms 1099 are issued by businesses, but if your business is paying in virtual currency, consider Forms 1099.

Gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in your hands. This point can be a huge issue, and is not an easy subject to summarize. Valuation swings can matter.

How much compliance there is

It takes time for people to adapt, and that is one reason compliance may be poor so far. Besides, digital currency is *meant* to be anonymous. Businesses may be less inclined to start handing out IRS Forms 1099 if recipients of those forms may go somewhere else.

Last year, the IRS started fighting to obtain vast amounts of data on Bitcoin and other digital currency transactions. In late 2016, a federal court authorized the IRS to serve a John Doe Summons on Coinbase, Inc. The IRS wants information on the site's users and their transactions. Some Coinbase users, led by Mr. Jeffrey K. Berns, moved to intervene in the IRS's case.

They argued that the IRS request threatened their privacy. In turn, the IRS argued that Mr. Berns has already identified himself as a user of Coinbase, so he can hardly object that his privacy is threatened. The IRS used a John Doe Summons to get the names of Swiss bank account holders from UBS. Offshore banking changed forever, with all other Swiss (and other) banks following suit.

The IRS ended up collecting over $10 bln. The IRS is pursuing Coinbase in the same way. As one indication that the IRS may be after big players, the IRS reportedly dropped its request for customer records from Coinbase to those accounts with transactions over $20,000. Bigger transactions mean bigger taxes, and bigger penalties.

As has been widely reported, the IRS claims that only 802 people declared a capital gain or loss related to Bitcoin in 2015. The IRS wants more reporting. It's using software to find Bitcoin users who have failed to report profits. An IRS contract with Chainalysis, a provider of of Anti-Money Laundering software, is at the root of this new IRS enforcement effort. If Chainalysis identifies owners of digital wallets, the IRS can take over.

Matching up transactions and tax returns is not that hard. Taxpayers who have unreported income could face taxes, interest, and potentially big civil penalties. It is fairly easy for the IRS to add 25 percent penalties to just about anything. If the IRS claims civil fraud, the penalty is 75 percent. Some cases could even end up as criminal tax cases.

Where to begin?

Basic reporting isn't that hard, and you have to start somewhere. Some taxpayers will go forward only, starting to report gains or losses on their next tax return. Some will amend past years, going back one, two, or three years.

Amending tax returns to ask for big tax refunds is a well-known audit trigger. Amending to report extra income and pay extra tax is probably much less so. Big offenders might even go back farther than three years, although the IRS often doesn't know what to do with amended tax returns more than three years out.

Of course, not everyone is going to look at this situation, or their own facts, with the same degree of concern. Some investors and businesses are may not be worried at all, and may assume that they have little risk of facing IRS problems. Some investors and businesses may react on the opposite end of the spectrum, making corrective filings for a number of past years and paying taxes without being asked.

Some people will surely come out in between. It's at least worth looking at your numbers and your exposure. In all of this, the IRS is generally considerably more forgiving if a taxpayer makes corrective filings before being caught or audited. Those who do not make filings until they are caught usually face harsher treatment.

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