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Robert W. Wood
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IRS Hunts Bitcoin User Identities With Software In Tax Enforcement Push

Is bitcoin in the IRS cross hairs? Users of bitcoin seem to be. 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. For example:

- 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 plenty on the cash. Or you sell some of the bitcoin to get dollars to pay the IRS.

- Payments using virtual currency made to independent contractors are taxable and payers must issue Form 1099. You can't enter "1,000 bitcoin" on the 1099. You must value it in dollars as of the time of payment. Valuation swings can be brutal.

- 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 can be a huge issue, and is not an easy subject to summarize.

- A payment made using virtual currency is subject to Form 1099 reporting just like any other payment made in property. Yes, this bears repeating. How much compliance there is in the real word remains to be seen.

It takes time for people to adapt, and that is one reason compliance may be poor so far. But part of the lack of compliance may also be the *nature* of digital currency. It is meant to be anonymous, and attracts some users for that reason. They may be less inclined to, for example, start handing out IRS Forms 1099. Recipients of those forms may go somewhere else.

All of this leaves the IRS wondering how to get a piece of the action. That's where enforcement comes in. 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 digital currency transaction hub. 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 was not properly calibrated and threatened their privacy. In turn, the IRS argued that Mr. Berns already identified himself as a Coinbase user, so could not say his privacy was threatened. It is worth remembering that the IRS used a John Doe Summons to get names of Swiss bank account holders from UBS. After that, offshore banking changed forever, with all other Swiss (and other) banks eventually coming clean. The IRS ended up collecting over $10 billion.

The IRS pursued Coinbase in the same way. Small fries may be OK, though. The IRS agreed to limit its request for customer records from Coinbase to accounts with transactions over $20,000. Beyond that, the IRS will clearly do more data mining for digital currency users. Reports about compliance suggest the IRS may need to. Reports underscore IRS claims that only 802 people declared a capital gain or loss related to bitcoin in 2015. With millions of transactions, 802?

This suggests that the bulk—the vast bulk—of bitcoin transaction are simply not reported. With millions of transactions and the meteoric rise of bitcoin from under $100 to over $4,000 in just a few years, the IRS seems to be missing out. That is where IRS tech comes in. Well, private tech then. It has been widely reported that the IRS is using software to find bitcoin users who have failed to report profits. The *Daily Beast* revealed the Chainalysis contract that 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 hidden income could face taxes, and potentially big civil penalties. Some cases could even end up as criminal tax cases. The IRS is generally more forgiving if a taxpayer makes corrective filings before being caught or audited. Those who do not make filings until they are caught could face harsher treatment. Remember, the IRS treats Bitcoin and other digital currencies as property. That means sales could give rise to capital gain or loss, rather than ordinary income. Be careful out there.

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