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IRS Intensifies Hunt For Crypto Tax Cheats

The IRS is taking steps to build cases against taxpayers who fail to report cryptocurrency. Despite more awareness of tax rules today, the IRS appears to believe that millions of transactions may be unreported. Taxpayers may think they will not be caught, but the risks are growing, and the best way to avoid penalties is to disclose and report as accurately as you can. Taxpayers may think that the IRS may penalize them, but might assume that they do not need to worry about criminal exposure. Yet violators can face large penalties or even criminal investigation. Anyone convicted of tax evasion can face up to 5 years in prison and fines as high as \$250,000.

Eric Hylton from the IRS Criminal Investigation Division was recently asked to head the Small Business/Self-Employed Division of the Internal Revenue Service. IRS Commissioner Chuck Rettig has moved to increase criminal investigations too. Last year's IRS letters to 10,000 crypto taxpayers was just a start. Recipients who received and ignored those letters might be vulnerable. After receiving such a letter, it is harder to say you made an innocent mistake or misunderstood. The IRS draft 2019 Form 1040 contained a question targeting cryptocurrency too. 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.

That should tell you something. After all, the Department of Justice Tax Division has successfully argued that the mere failure to check a box, in the FBAR reporting context, is *per-se* willfulness. Willful failures, as opposed on non-willful actions, carry higher penalties and an increased threat of criminal investigation. The Department of Justice Tax Division is working with the IRS,

and is already involved in several criminal prosecutions involving cryptocurrency. Clearly other cases are coming. The IRS's Criminal Investigation Division is even meeting with tax authorities from other countries to share data and enforcement strategies to find potential cryptocurrency tax evasion.



IRS Notice 2014-21 states that cryptocurrency is property for tax purposes. As such, you pay taxes if you realize a gain, and you may be able to claim losses when you trigger a loss. You must know when you bought the cryptocurrency, how much you paid, and what you received for it. For stock and real estate, this may be simple. For cryptocurrency, it can be much more difficult. The IRS FAQs state that all income, gain, or loss involving virtual currency must be reported, regardless of whether you received a Form W-2 or Form 1099. Many cryptocurrency investors have made purchases at multiple times and for many years. The IRS says 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. 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 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. They may have trouble deciphering exactly when they *received* mined cryptocurrency for purposes of determining 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 (FIFO) 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 continuing reporting efforts going forward.

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. Besides, IRS FAQs are not technically legal authority. Even so, the new guidance *does* include Revenue Ruling 2019-24, in addition to the increased FAQs. This revenue ruling addresses common questions regarding the tax treatment of a cryptocurrency hard fork and air drops. If you are not compliant with the IRS, in some cases, normal amended returns or quiet disclosures may be fine. In other cases, formal voluntary disclosures to the IRS may be appropriate. There can be no mistaking the IRS's intent to make big enforcement and revenue drives, and it is likely that there are going to be some big, public and messy examples of IRS enforcement efforts.

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