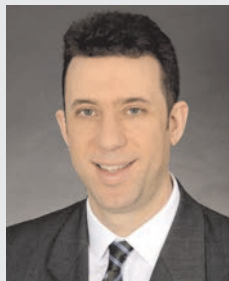


IRS Targets Bitcoin Users, But Is Coinbase the Next UBS?

by Dashiell C. Shapiro



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In this article, Shapiro considers the IRS's recent John Doe summons to Coinbase and discusses the lessons that history offers taxpayers with unreported income from digital currency transactions, including bitcoin.

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The IRS's efforts to find untaxed funds hidden in offshore accounts have proved wildly successful, and its hardball tactics are well known. The IRS has prosecuted big foreign banks for helping Americans stash money overseas and obtained large settlements in these cases.¹ The IRS has also prosecuted high-profile individual taxpayers for hiding their money in offshore accounts.² Finally, the IRS strong-armed both foreign governments³ and foreign banks⁴ to make them turn over more data about U.S. taxpayers holding accounts overseas.

But perhaps the greatest coup in the IRS's strategy has been to simultaneously extend a carrot to scared taxpayers. The message is clear: If you hide funds offshore, we will find you. But if you come forward and pay penalties and back taxes in the offshore voluntary disclosure program or through

the streamlined initiative, we'll work with you. And many taxpayers have taken the bait. Offshore account collections are now more than \$10 billion and are still rolling in.⁵

However, offshore collections will slow down over the next decade because many U.S. taxpayers who hid funds overseas have already come forward, and a hungry IRS will be looking for new sources of untapped revenue. Recent events indicate that the IRS may be hoping to find the "next big thing" in the world of digital currencies.

The IRS is leading a charge to enforce a John Doe summons against Coinbase Inc., which is an online platform and digital currency "wallet" that allows its users to exchange and transact with digital currencies such as bitcoin.⁶ If it succeeds, the IRS may have a treasure trove of data cataloging who was buying and selling bitcoin and other digital currencies. Some of these transactions, possibly most of them, have never been reported to the IRS.

This article examines the Coinbase summons fight in the broader context of the IRS's efforts to find tax cheats. Is the IRS's offshore account enforcement approach the model for enforcement regarding digital currencies? It might be. It's likely the IRS is considering issuing summonses to other digital currency trading platforms for their user data.

The IRS (or other U.S. government agency) might also be considering whether to bring charges against digital currency trading platforms such as Coinbase or other way stations that facilitate these trades. It is unclear what those charges would be, but a decade ago few saw prosecutions of UBS and other well-heeled banks coming.⁷ Indeed, the initial

⁵Wood, "IRS Offshore Account Collections Top \$10 Billion, FATCA Hunt Continues," *Forbes*, Oct. 24, 2016.

⁶Wood, "Court Allows IRS John Doe Summons for Bitcoin, Other Virtual Currencies," *Forbes*, Nov. 30, 2016.

⁷Before the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations issued its report on July 17, 2008, the discussion largely concerned whether UBS would comply with the summons. Senate staff report, "Tax Haven Banks and U.S. Tax Compliance" (July 17, 2008). Whether UBS would be prosecuted for facilitating tax evasion was not a focus of the Senate inquiry. See, e.g., Kristen A. Parillo, "Federal Court Grants Request for Info From Swiss Bank," *Tax Notes*, July 2, 2008, p. 24 ("Under Swiss law, disclosure without the consent of the account party would result in a criminal violation to the disclosing bank and/or its bankers. On

(Footnote continued on next page.)

¹David S. Hilzenrath and Zachary A. Goldfarb, "UBS to Pay \$780 Million Over U.S. Tax Charges," *The Washington Post*, Feb. 19, 2009; Christie Smythe, "Credit Suisse Judge Accepts \$2.6 Billion Tax Plea Deal," *Bloomberg*, Nov. 21, 2014.

²Robert W. Wood, "Beanie Babies Founder Ty Warner to Pay \$53M for Offshore Tax Evasion," *Forbes*, Sept. 18, 2013.

³Pascal Fletcher and Jane Sutton, "U.S./UBS Deal Ramps Up Pressure on Tax Havens," *Reuters*, Aug. 19, 2009.

⁴Wood, "100 Swiss Banks Get Ultimatum: Hand Over Americans or Face U.S. Prosecution," *Forbes*, Oct. 13, 2014.

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chatter was that UBS might face legal troubles *at home* for breaking Swiss banking secrecy laws, if it complied with the IRS’s summons.⁸ So the tides can change quickly.

As for the IRS’s summons to Coinbase, the more data the IRS accumulates, the more it might be able to piece together transactions that many digital currency users assumed were anonymous. For individuals and businesses that have dealt in digital currencies, this is an understandable worry. This article addresses potential common reporting issues and what taxpayers and advisers can do to prepare in case this is the IRS’s next large-scale enforcement undertaking.

The John Doe Summons

The IRS’s summons to Coinbase seeks records on the site’s users whose identities the IRS does not yet know. The IRS has the power to examine any data that may be relevant to determining the correct tax owed by any taxpayer. Its goal here is to use this broad power to obtain heaps of data on digital currency transactions. What’s more, the IRS hopes to gather leads on who it should target for audits. This is a classic John Doe summons, of the type that the IRS used to masterful effect in its offshore account enforcement efforts.⁹

Section 7609(f) authorizes such summonses, but the burden is slightly higher than that of a typical summons targeted at one individual.¹⁰ For a John Doe summons to be allowed:

- it must relate to the investigation of a particular person or ascertainable group or class of persons;¹¹
- there must be a reasonable basis for believing that that person or group or class of persons may fail or may have failed to comply with any provision of the tax law;¹² and

the other hand, UBS AG may find itself between a rock and a hard place regarding making such disclosures, because failure to honor the John Doe summons could result in severe fines and penalties, a suspension of all U.S. activities of UBS, or even worse, legal action.”)

⁸Randall Jackson, “Switzerland Reacts to U.S. John Doe Summons,” *Tax Notes*, July 7, 2008, p. 120 (“UBS may find itself in a precarious position because although tax evasion is not a crime in Switzerland, divulging bank customer information is illegal; hence, it may want to request that additional Swiss authorities become involved with the overall investigation, according to the Agence France-Presse report.”).

⁹Justice Department press release, “Court Authorizes IRS to Issue Summonses to Discover U.S. Taxpayers With Offshore Bank Accounts at Belize Bank International Limited and Belize Bank Limited” (Sept. 16, 2015).

¹⁰Section 7609(f).

¹¹Section 7609(f)(1).

¹²Section 7609(f)(2).

- the information sought to be obtained from the examination of the records or testimony (and the identity of the person or persons regarding whose liability the summons is issued) must not be readily available from other sources.¹³

The IRS summons to Coinbase appears to meet these criteria, at least at first glance.

The United States District Court for the Northern District of California entered an order authorizing the IRS to serve the summons on Coinbase. The goal of the IRS summons is to obtain information about U.S. taxpayers who conducted transactions in a convertible virtual currency from 2013 to 2015 through Coinbase’s trading platform.¹⁴

On March 16, 2017, the United States filed a separate petition against Coinbase to enforce a new summons.¹⁵ The new summons seeks similar information on customer transactions, but has a more extensive declaration regarding the purpose of the summons.¹⁶ The declaration noted that from 2013 to 2015, less than 1,000 tax returns out of the more than 120 million electronically filed individual returns in each year appear to have reported bitcoin transactions on Form 8949.¹⁷ The government suggests that this indicates widespread noncompliance in this area, and that the summons is necessary to root it out.

Coinbase and its customers will probably face a steep uphill battle in blocking the IRS’s summons enforcement efforts. Because of the wide latitude courts typically grant to the IRS to request information that could be relevant to tax investigations, the IRS wins most of its summons enforcement cases.¹⁸

Given this backdrop, the best outcome for Coinbase and its customers may be to have the summons limited or modified in some way. That could be because of actions of the court, or it could come about by actions of the parties themselves in a settlement on the issues. What is clear, however, is that a broad-based enforcement of the IRS summons could put many digital currency users in trouble with the IRS.

¹³Section 7609(f)(3).

¹⁴Justice Department press release, “Court Authorizes Service of John Doe Summons Seeking the Identities of U.S. Taxpayers Who Have Used Virtual Currency” (Nov. 30, 2016).

¹⁵See *United States v. Coinbase Inc.*, No. 3:17-cv-01431 (N.D. Calif. Mar. 16, 2017).

¹⁶*Id.* Pacer docket 1:1, Declaration of David Utzke.

¹⁷*Id.* paragraphs 12 and 13. Eight hundred and seven individuals reported transactions on Form 8949 using a property description likely related to bitcoin in 2013, 893 did so in 2014, and 802 did so in 2015.

¹⁸Nina Olson, “Most Litigated Issues No. 4: Summons Enforcement Under IRC Sections 7602, 7604, and 7609,” National Taxpayer Advocate 2013 Annual Report to Congress, at 365 (Dec. 2013).

Coinbase to the Rescue? Maybe Not

Coinbase has said it is committed to customer privacy and will oppose the government's efforts to obtain its customer account information.¹⁹ It said it looks forward to "opposing the DOJ's request in court after Coinbase is served with a subpoena."²⁰ That could mean an appeal of the district court's order, and more delay.

But Coinbase may want to tread lightly. Before it set its sights on digital currency transactions, the IRS plowed through Swiss bank records for evidence of U.S. taxpayers concealing taxable income. Ultimately, the IRS and the Justice Department targeted the banks themselves. UBS, one of the prime offenders in the offshore banking scandal, agreed to pay a fine of \$780 million in its deferred prosecution agreement with the Justice Department.²¹ Credit Suisse paid even more.²² Some banks were driven out of business.²³

Coinbase may be looking at this history and wondering if it is going to end up in the IRS's crosshairs like the Swiss banks did. It's not yet clear what, if anything, Coinbase may have done wrong. But then again, it was difficult to envision grounds for bringing criminal charges against the leading Swiss banks before the IRS went down this path.²⁴ The digital currency transactions Coinbase facilitates take place under an uncertain legal regime, to say the least.²⁵ Coinbase would be wise to worry that if it pushes back too hard against the IRS summons, it may become the target of government enforcement efforts.

In considering whether to prosecute (or even threaten to prosecute) Coinbase and other digital currency trading platforms, one significant factor the government may consider is likely to be the degree of "cooperation" Coinbase and others have offered with the government's information requests.²⁶ Therefore, opposing the IRS summons may be a strike against Coinbase down the road.

¹⁹"Protecting Customer Privacy," The Coinbase Blog, Nov. 18, 2016.

²⁰*Id.*

²¹Hilzenrath and Goldfarb, *supra* note 1.

²²Smythe, *supra* note 1.

²³Rupert Neate, "Oldest Swiss Bank Wegelin to Close After Admitting Aiding US Tax Evasion," *The Guardian*, Jan. 4, 2013.

²⁴*Supra* notes 7 and 8.

²⁵*See, e.g.*, Timothy B. Lee, "Feds Charge Bitcoin Start-Up Founder With Money Laundering," *The Washington Post*, Jan. 27, 2014; *but see* "New York Warms Up to This Bitcoin Exchange With New License," Reuters, Jan. 17, 2017 (New York Department of Financial Services announces that it granted a virtual currency and money transmitter license to Coinbase).

²⁶Justice Department Tax Division, "Criminal Tax Manual" (2012) (listing "willingness to cooperate" as one of the relevant considerations that should be weighed in federal law enforcement priorities).

If the IRS Gets the Data — What Next?

Even if the IRS gets its hands on the user data soon, audits may not begin immediately. The information will surely be difficult for the government to sort through. Simply selling or buying bitcoins does not necessarily mean someone owes additional tax, even if large quantities of bitcoins have changed hands.²⁷ There are still many dots to connect, and it may take the government time to do so.

For those who have not properly reported all their digital currency transactions to the IRS, now is a good time to consider cleaning up past filings. The government's recent pressure on offshore account holders is full of good lessons.

Many of those who came forward and fixed their offshore account filings sooner faced lower penalties and no criminal charges.²⁸ On the other hand, many of those who waited to come forward faced higher penalties, and, in some cases, even criminal investigations.²⁹ Many taxpayers who figured that the whole mess would blow over ended up spending much more money later, because of the substantial increase to the miscellaneous offshore penalty.³⁰

What's a Coinbase User to Do?

Digital currency users should heed these lessons. It simply is not worth the risk of waiting to see if the IRS will find you. Whether one needs to fix filings or pay additional tax, it's always best to consider options sooner. Here are some topics digital currency users may want to discuss with an accountant or tax lawyer.

- Should they amend past income tax returns? Payments received in bitcoin or other digital currencies may be considered income, and failure to fully report the income on tax returns can lead to civil and even criminal penalties.³¹ This is a delicate matter, though, because filing amended returns can also trigger immediate IRS scrutiny. So how to do this requires careful consideration and planning.
- Must they file information reporting returns? For digital currencies held in accounts offshore, Forms 8938 or foreign bank account reports

²⁷*See* section 1012.

²⁸Andrew Velarde, "Practitioners Debate Fairness of Lack of IRS OVDP Retroactivity," *Tax Notes*, Aug. 7, 2014, p. 660 (noting, "consistent penalty rate increases in the programs rolled out between 2009 and 2012, from 20 percent to 25 percent to 27.5 percent").

²⁹*See supra* notes 7 and 8.

³⁰Wood, "IRS Increases Offshore 'Amnesty' Penalty From 27.5 Percent to 50 Percent, Makes Other Changes," *Forbes*, June 18, 2014; *see also* IR-2012-64/65. The 2011 OVDI required a 25 percent FBAR-related penalty.

³¹Notice 2014-21, 2014-16 IRB 938.

may be required.³² The “location” of a virtual bitcoin account may be hard to identify, but if a taxpayer has had more than \$10,000 worth of bitcoin or other digital currencies stored on a computer or server located outside the United States, they may be responsible for filing these information reports.³³

Businesses dealing in digital currencies may have the same concerns as individual users. But they may face these additional questions.

- Have they filed all the necessary Forms 1099? Three years ago, the IRS issued a notice saying that bitcoin is property, not currency. The IRS said that Forms 1099 must be filed for payments to independent contractors in digital currencies.³⁴
- Have they filed all the necessary Forms W-2? The same IRS notice said that wages paid to employees in digital currencies must be reported on a Form W-2 and are subject to income tax withholding and payroll taxes.³⁵ Failure to pay payroll taxes can lead to civil penalties on the individual officers of the business, and even criminal charges.³⁶

There may still be some time before the IRS begins wholesale digital currency audits. But for those who are at risk, now is a great time to prepare. Either a tax attorney or an accountant may be able to help, though if there is a risk of criminal exposure, it may be prudent to consider how to get attorney-client privilege with your accountant.³⁷

Capital Gains Issues

Even for taxpayers who have done their best to report their digital currency gains and losses, there

may be problems. Notably, the IRS treats bitcoin and other digital currencies as property, not currency. That means some sales could give rise to capital gain rather than ordinary income.

Thus, some digital currency users who have been reporting their digital currency transactions might not have been reporting them correctly. There could be numerous spillover tax effects. For example, the tax code limits the amount of capital losses that can be carried forward annually to \$3,000. Bitcoin prices have swung wildly, so there may be taxpayers with significant losses that cannot be used to offset ordinary gains.

Big Dollars — Big Problems

Even if Coinbase is not a target of the government’s efforts now, it might become one. The Coinbase John Doe summons is probably the first shot in a bigger war against unreported digital currency transactions. Everyone involved in the nascent industry should prepare and study the example of the IRS’s offshore account enforcement efforts for clues.

The example offers several lessons: don’t wait too long and don’t assume the IRS will never find you. The IRS probably will. In addition to those lessons, the IRS’s offshore enforcement regime might actually prove to be a redeeming feature for some U.S. taxpayers. Consider a U.S. taxpayer who held bitcoin on a computer or a server located outside the United States but did not file FBARs or report any income from sales of the currency. In an odd twist the taxpayer’s advisers might want to consider the OVDP as a way to clear up those past filing issues. The OVDP might even offer some advantages over other disclosure routes.

Swiss Banks and their U.S. customers thought that the U.S. government would never be able to pierce their banking secrecy laws. They were wrong. Bitcoin and other digital currency users who trust in the anonymity of virtual currencies are likely in for a similar shock. ■

³²See 31 U.S.C. section 5314; 31 CFR section 1010.350.

³³*Id.*

³⁴Notice 2014-21.

³⁵*Id.*

³⁶See sections 6672 and 7202.

³⁷Wood, “Neat Trick? Attorney-Client Privilege From an Accountant,” *Forbes*, Oct. 28, 2012.