

War On Alternative Currencies Heating Up

By Dashiell C. Shapiro and Robert W. Wood

The Internal Revenue Service's war on alternative currencies is heating up, and many will be affected, though how — and how seriously — remains to be seen. A federal district court has ordered that Coinbase Inc. should turn over its customer account information to the government. *See Order Granting Ex Parte Petition For Leave to Serve "John Doe" Summons*, 3:16-cv-06658-JSC (N.D. Cal.).

Many Bitcoin and other digital currency users are worried that the IRS will get their account information from Coinbase. What's more, the IRS can use it to audit them, or worse, to mount a criminal investigation. If they are not yet worried, they should be. But is it time to panic? Not quite.

Coinbase in the past has said it is committed to customer privacy and will oppose the government's efforts to obtain its customer account information. That could mean an appeal of the district court's order, and more delay. But even if the IRS gets its paws on the user data soon, it may not immediately lead to audits.

The information will surely be difficult for the government to sort through. Simply sending or receiving bitcoins does not necessarily mean someone owes additional tax, even if large quantities of bitcoins have changed hands. Many Bitcoin transactions are merely swapping "fiat" and other digital currencies into bitcoins and vice-versa. There are still many dots to connect, and it may take the government time to do so.

Even so, should you really count on all these things breaking your way? Hardly. Digital currency users should be concerned, and should prepare. After all, the IRS taxes all income, so any transactions, gains, losses and trades are supposed to be reported and tallied on your tax returns.

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 filled with good lessons. For the past decade, the IRS has relentlessly pursued Americans with unreported foreign accounts.

In some cases, the IRS has found it hard to tie foreign accounts to particular U.S. taxpayers, and to tax cheats specifically. The government has often been slow to connect the dots. But slow or not, the government almost always gets what it wants in the end. The IRS's efforts have been wildly successful, and offshore account collections have now topped a staggering \$10 billion.

The IRS is likely eyeing digital currency transactions as a similar treasure trove of unpaid taxes. The track record of offshore account compliance enforcement is telling, if not downright frightening. Many of those who fixed their offshore account filings and came forward early faced lower penalties and no criminal charges. On the other hand, many of those who waited to come forward faced higher penalties, and, in some cases, even criminal investigations.

Some taxpayers figured that the whole mess would blow over, and yet ended up spending much more money later on audits and legal fees. 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 you need to fix your filings or pay additional tax, it's always best to consider your options sooner rather than later.

With that in mind, there are some topics digital currency users may want to discuss with an accountant or tax lawyer. Either may be able to help. However, if someone is at risk of criminal exposure, they may want to consider how to get attorney-client privilege with their accountant (such as through a *Kovel* agreement). In any case, here are some questions to discuss:

- Should I amend past income tax returns? Payments you received in bitcoin or other digital currencies may be considered income, and failure to fully report the income on your returns can lead to civil and even criminal penalties. This is a delicate matter, though, because filing amended returns can also trigger immediate IRS scrutiny. So how to amend requires careful consideration and planning.
- Do I need to file information reporting returns? For digital currencies held in accounts offshore, Forms 8938 or FBARs may be required. The "location" of a virtual Bitcoin account may be hard to pin down, but if you have had over \$10,000 USD worth of bitcoin or other digital currencies stored on a computer or server located outside the U.S., you may be responsible for filing these information reports.

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

- Have we filed all the necessary Forms 1099? Two years ago, the IRS issued Notice 2014-21, which said that Bitcoin is property, not currency. The IRS said that Forms 1099 must be filed for payments to independent contractors in digital currencies.
- Have we 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. Failure to pay payroll taxes is serious, and can lead to civil penalties on the individual officers of the business, and even criminal charges.

Even if all the required taxes have been paid, failure to file the necessary forms may lead to a deluge of penalties. So digital currency users should check their exposure now. There may still be some time before the IRS begins wholesale digital currency audits. But for those who may be at risk, now is a great time to prepare.

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