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## The IRS is Aggressively Pursuing Taxes on Cryptocurrency Transactions

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For the first time this year, the very first question on the standard IRS Form 1040, *U.S. Individual Income Tax Return*, is whether “at any time during 2020 did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency.” In other words, it is the very first piece of information the IRS wants to know, right after a person’s name and address. The subtlety of the placement of this question is not lost on anyone. The IRS obviously believes that there is significant under-reporting (and under-paying) of tax obligations relating to cryptocurrency transactions and it is seeking to increase the revenue stream to the government from those transactions.

In 2019, the cryptocurrency question was on Schedule 1 of the tax form. That schedule is used for reporting certain adjustments or additional income; thus, many filers do not use it. The prominent placement on the 2020 Form 1040 means that the 150 million people who use that form will have to answer the question. Moreover, while the question itself does not in any way change the obligation to pay taxes on cryptocurrency transactions, there is a difference to a filer between overlooking that obligation on the one hand, and answering a question untruthfully on the other. The existence of the question will likely compel tax preparers to affirmatively ask the question of

their clients. And, an inaccurate answer could be used against the filer by the IRS.

### DEFINING CRYPTOCURRENCY ACROSS THE U.S. GOVERNMENT

How does the U.S. government treat cryptocurrency? The answer depends on which government agency one is talking about. To the Securities and Exchange Commission, cryptocurrency can be a security. The SEC has brought numerous cases (civil and criminal) against parties who sold cryptocurrency tokens without filing a registration statement for the offering and without the offering satisfying any exemption from registration.<sup>1</sup> The SEC position is that the offerings for such tokens qualify as securities under the Commission’s longstanding *Howey* test.<sup>2</sup>

To the Commodities Futures Trading Commission (CFTC), cryptocurrencies are commodities. On September 17, 2015, the CFTC brought its first cryptocurrency action against an unregistered bitcoin trading platform. The CFTC charged Coinflip Inc. and its chief executive officer with operating a facility for the trading or processing of commodity options (offering to connect buyers and sellers of bitcoin option contracts) without complying with the Commodity Exchange Act or CFTC Regulations otherwise applicable to swaps. The most significant part of the CFTC’s Order was the following unambiguous statement about cryptocurrencies: “[b]itcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.”<sup>3</sup>

But there is still more confusion among the alphabet soup of agencies of the U.S. government. The Financial Crimes Enforcement Network (FinCEN) is a bureau of the U.S. Department of Treasury that, among other things, collects and analyzes information about financial transactions in order to combat domes-

<sup>1</sup> See *SEC v. Coinseed, Inc. And Delgerdalai Davaasambuu*, Docket No. 1:21-cv-01381 (S.D.N.Y. Feb. 17, 2021) (complaint).

<sup>2</sup> See *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

<sup>3</sup> See <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

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tic and international money laundering, terrorist financing, and other financial crimes. As far back as 2013, it considered virtual currencies to be money.<sup>4</sup> And, finally, the U.S. Office of Government Ethics takes the position that virtual currency qualifies as “property held . . . for investment or the production of income” under the Ethics in Government Act, meaning that executive branch employees are required to report their holdings of virtual currency on their public or confidential financial disclosure report, subject to applicable reporting thresholds for property held for investment or the production of income.<sup>5</sup>

For purposes of this article, it is of course the position of the IRS that is relevant. The IRS focus on cryptocurrency is relevant to both taxpayers who buy and sell cryptocurrency, as well as businesses or individuals that transact with such taxpayers. Taxpayers need to be familiar with the IRS positions on the tax treatment of cryptocurrency transactions. Third parties can find themselves contending with IRS requests for information about taxpayers and their cryptocurrency transactions. In some circumstances, third-party recordkeepers can incur financial or regulatory obligations such as having to keep records or report transactions.

## **EFFORTS TO INCREASE REVENUE COLLECTION**

Taxpayers should be aware that the IRS first introduced its guidance regarding the tax treatment of virtual currencies in 2014, in Notice 2014-21. The IRS said that, for federal tax purposes, virtual currency is treated as property — not as money — and that general tax principles applicable to property transactions apply to transactions using virtual currency. Thus, a taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received. Furthermore, if virtual currency is used to pay for an item or otherwise exchanged for property, the taxpayer has a taxable gain if the fair market value of property received in exchange for virtual currency exceeds the taxpayer’s adjusted basis for the virtual currency. Notice 2014-21 further provides that (1) virtual currency received by an independent contractor for performing services constitutes self-employment income, (2) a payment made using virtual currency is subject to information

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<sup>4</sup> See <https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering>.

<sup>5</sup> See [https://www.oge.gov/Web/OGEL.nsf/News+Releases/D9038B8D8DE24D88852585BA005BEC34/\\$FILE/LA-18-06.pdf](https://www.oge.gov/Web/OGEL.nsf/News+Releases/D9038B8D8DE24D88852585BA005BEC34/$FILE/LA-18-06.pdf).

reporting to the same extent as any other payment made in property, and (3) payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. In other words, there are many ways that taxpayers can run afoul of tax laws when it comes to cryptocurrency and the IRS has brought the issue into sharper focus by placing the cryptocurrency question at the top of the Form 1040.

But taxpayers *and* third parties should know that this is only one of the steps the IRS has taken to beef up its enforcement efforts. The IRS labeled one initiative “Operation Hidden Treasure,” which, as first reported by Forbes, was announced during a March 5, 2021, Federal Bar Association presentation on fraud enforcement priorities by Damon Rowe, the Director of the Office of Fraud Enforcement at the IRS.<sup>6</sup> As Forbes reported, Operation Hidden Treasure is comprised of agents who are trained in cryptocurrency and virtual currency tracking, and who are focused on taxpayers who omit cryptocurrency income from their tax returns. It is a partnership between the civil office of fraud enforcement and the criminal investigation unit, and seeks to root out tax evasion from cryptocurrency owners.

## **IRS ENFORCEMENT EFFORTS**

The location of a question about cryptocurrency transactions at the top of the individual tax return Form 1040 is indicative the priority of the issue for the IRS.

Another tool the IRS is using as part of its cryptocurrency initiative is the “John Doe summons.” In the past, the IRS used John Doe summonses to identify taxpayers who had not paid their tax obligations by serving them on credit card companies such as American Express, MasterCard, and Visa, as well as payment services such as PayPal. Now, the IRS is applying this tool to cryptocurrency exchanges. While a typical summons is issued when the IRS knows the name of the specific taxpayer, the IRS uses a John Doe summons to obtain the names of all taxpayers in a certain group. For example, a 2008 John Doe summons was a key step in the IRS finding U.S. taxpayers with accounts in Swiss banks. A John Doe summons is not only a potential source of concern for taxpayers who may have cryptocurrency tax obligations, but it can also impose substantial burdens on the cryptocurrency exchange or other party upon with the IRS serves the summons.

A John Doe summons must be approved by a federal district court judge, and on April 1, 2021, a fed-

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<sup>6</sup> Amber Gray-Fenner, *IRS Adds New Guidance But Form 1040 Cryptocurrency Question Is Still Causing Confusion*, Forbes (Mar. 5, 2021).

eral court in the District of Massachusetts entered an order authorizing the IRS to serve a John Doe summons on Circle Internet Financial Inc., a digital currency exchange headquartered in Boston.<sup>7</sup> The government sought information about U.S. taxpayers who conducted at least the equivalent of \$20,000 in transactions in cryptocurrency during the years 2016 to 2020. The IRS requested that Circle produce records identifying such U.S. taxpayers, along with other documents relating to their cryptocurrency transactions.

According to the Justice Department, the government's petition does not allege that *Circle* has engaged in any wrongdoing in connection with its digital currency exchange business. Rather, according to the court's order, the summons seeks information related to the IRS's "investigation of an ascertainable group or class of persons" that the IRS has reasonable basis to believe "may have failed to comply with any provision of any internal revenue laws[.]"

The IRS is simultaneously pursuing authority to issue John Doe summonses against Kraken, a California cryptocurrency exchange. Once again, the government is asking about U.S. taxpayers who conducted at least the equivalent of \$20,000 in transactions in cryptocurrency during the years 2016 to 2020. The IRS has faced a more skeptical court there. On March 31, 2021, the federal court in the Northern District of California issued an order to show cause in which it said that the IRS had likely made a sufficient showing to satisfy the requirements of the statute for issuing a John Doe summons, but the court had concerns with respect to scope of the request (which the statute requires be "narrowly tailored").<sup>8</sup> On April 15, 2021, the IRS narrowed its requests, although it continues to seek substantial information from Kraken. The IRS does not allege that Kraken engaged in any wrongful conduct.

The proposed summons seeks broad categories of information such as "complete user preferences," "[a]ny other records of Know-Your-Customer due diligence," (KYC) and "[a]ll correspondence between Kraken and the User or any third party with access to the account pertaining to the account," among other similarly expansive requests. The court therefore required the IRS to show cause why the petition should not be denied for failure to meet the "narrowly tailored" requirement of the statute. In doing so, the IRS was required to address specifically "why each cat-

egory of information sought is narrowly tailored to the IRS's investigative needs, including whether requests for more invasive and all-encompassing categories of information could be deferred until after the IRS has reviewed basic account registration information and transaction histories." In responding to the court's show cause order, the IRS narrowed its request for KYC information to only seek the responses to the employment, net worth, and source of wealth questions, and the IRS observed that it expects that these responses will only be provided for a limited number of account holders related to Kraken "pro level" accounts.

As these two cases show, the IRS is seeking broad information related to those engaged in cryptocurrency transactions, and third-party recordkeepers will face onerous requirements to produce such information. "Tools like the John Doe summons authorized [in the Circle case] send the clear message to U.S. taxpayers that the IRS is working to ensure that they are fully compliant in their use of virtual currency," said IRS Commissioner Chuck Rettig.<sup>9</sup> "The John Doe summons is a step to enable the IRS to uncover those who are failing to properly report their virtual currency transactions. We will enforce the law where we find systemic noncompliance or fraud."

The broad information gathering the IRS is conducting as part of its cryptocurrency enforcement effort will also likely lead to a scrutiny of both the broader community of businesses and people that may not be primarily engaged in cryptocurrency transactions, but who provide or receive services for cryptocurrency, and related reporting obligations. Like earlier IRS enforcement initiatives, this can lead to a focus on reporting and withholding obligations. Some of the issues that have arisen as a result of earlier similar IRS enforcement initiatives have included:

- **Withholding on payments to foreign persons:** Generally, a foreign person is subject to a U.S. tax of 30% on its U.S. source income, subject to certain exceptions or reductions. Withholding refers to rules that requires 30% withholding on a payment of U.S. source income and the filing of required forms. Payments in cryptocurrency are not exempt from these requirements, but its relative novelty has led some to overlook compliance issues.
- **Foreign account and transaction reporting:** U.S. citizens and residents who hold more than \$10,000 in foreign accounts are required to report the accounts on Form 114, *Report of For-*

<sup>7</sup> See <https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-0>.

<sup>8</sup> See <https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-0>.

<sup>9</sup> See <https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-0>.

*Foreign Bank and Financial Accounts (FBAR)*. Currently, FinCEN has stated that a foreign account holding virtual currency is not reportable on the FBAR (unless it holds reportable assets besides virtual currency), but FinCEN has stated an intention to amend those regulations to require reporting of cryptocurrency. Separately, those with certain foreign financial assets in excess of \$50,000 must also report foreign accounts (and certain other foreign financial asset information) on Form 8938, *Statement of Specified Foreign Financial Assets*. U.S. persons and residents should be aware that (1) there is potential ambiguity in these rules as applied to cryptocurrency, (2) the government has announced an intent to change

the rules, (3) there has been continuing speculation about IRS positions regarding reporting obligations, and (4) reporting for foreign assets can be complicated and expose U.S. persons and residents to substantial penalties.

Those that are transacting in cryptocurrency, whether as a trading vehicle or merely to pay for goods or services, should obtain appropriate tax advice. As a general rule, disclosing one's transactions to a qualified tax advisor and following legitimate advice can protect taxpayers from penalties (but not the underlying tax liabilities). The IRS has demonstrated it is taking steps to gather substantial information and will be pursuing those that do not comply with the rules.

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