ABA 2020 MIDYEAR TAX MEETING
BOCA RATON RESORT AND
CLUB, BOCA RATON, FL

A CLIENT WITH CRYPTOCURRENCY
JUST CALLED – WHAT NOW?

CCTP
Saturday, February 1, 2020
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A CLIENT WITH CRYPTOCURRENCY
JUST CALLED – WHAT NOW?

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Program Outline

• Introduction
• Means of Obtaining Cryptocurrency
• Cryptocurrency Guidance
• IRS Notice 2014-21 - Tax Reporting Rules for Cryptocurrency
• IRS Rev. Rul. 2019-24 – Airdrops and Hard Forks
• Special Tax Issues for Cryptocurrency
• Potential Foreign Disclosure Requirements
• IRS Civil Examination Considerations
• IRS Criminal Investigation Considerations
• Use of Voluntary Disclosure to Get into Compliance
• Future of Cryptocurrency Enforcement
• Glossary of Key Terms
As of 1/7/20
Introduction

- Cryptocurrency is a digital asset designed to work as a medium of exchange using cryptography to secure the transactions and to control the creation of additional units of the currency.

- Under the Bank Secrecy Act, virtual currency is a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. FinCEN typically distinguishes between convertible and non-convertible virtual currencies.

- Convertible virtual currencies either have an equivalent value in real currency, or act as a substitute for real currency.
Introduction

- Cryptocurrency is drawing increased attention from governments (e.g. House Financial Services Committee on Libra) and regulators around the world.

- Coinbase, Inc. (largest virtual currency exchange) released information for an estimated 14,000 customers. This information was a source for the IRS’s “educational letters.”

- Huge cryptocurrency market valuations and fluctuations.
  - $300 to $500 Billion Market Cap

- Some have made huge profits on cryptocurrency.
- Some are now experiencing large losses.
- There is now mainstream media attention.
- Increased acceptance by 100,000’s of retail establishments.
Introduction (cont.)

• At one point, there were 100,000’s of new users each week.

• In 2014, the IRS issued rules treating cryptocurrency as property, wherein treating it like currency may prove more easy to administer.

• The explosion of cryptocurrency has created challenging tax reporting issues with minimal further guidance from the IRS.

• Guidance reportedly is in the works, but there are so many issues with cryptocurrency that we shouldn’t expect the guidance to address all or even most outstanding issues.

• Nonetheless, taxpayers should expect IRS enforcement with respect to cryptocurrency.
IRS Commissioner Charles Rettig on Virtual Currency Letters: Take a Hint

If you received a letter from the IRS reminding you that taxpayers must pay taxes on virtual currency transactions, you’d better take action before the IRS does.

“If you get a letter, and your name is on the letter, and it’s your home address or the address that matches your tax return, and it’s from the IRS, and it’s encouraging you to maybe take a second look at your return . . . one might assume we had information,” IRS Commissioner Charles Rettig said at the National Association of Enrolled Agents conference in Las Vegas, further noting: “We didn’t send a letter to every seventh address. One might assume we had information, and we’re encouraging people to get there first,” he said.

Practitioners have urged taxpayers to be careful when responding to the IRS’s virtual currency tax compliance letters to avoid accidentally incriminating themselves.
# Cryptocurrency/Virtual Currency

## Virtual Currencies
- Bitcoin
- Bitcoin Cash
- Ethereum
- Litecoin
- 900+

## Exchanges
- Coinbase, Inc.
- Gemini
- Bitfinex
- Kraken
- 50+

## Diverse Uses
- Trading
- Investing
- Exchange of Goods/Services
- Illegal/Illlicit Activities
- ???

A Client with a Cryptocurrency Issue Just Called - What Now?
Means of Obtaining Cryptocurrency/Virtual Currency

• Mining/Proof-of-Work
• Exchanging Virtual Currency ("VC") for Sovereign (fiat) currency
• Exchanging VC for property (i.e. Barter) or services
• Exchanging VC for VC
• Hard Fork/Air Drops
• Initial Coin Offerings (ICOs)
Cryptocurrency/Virtual Currency Guidance

1. March 18, 2013 FinCEN’s Regulations to Persons Administering, Exchanging or Using Virtual Currencies FIN-2013-G001
2. Virtual Economies and Currencies, GAO 13-516 (May 2013)
7. May 9, 2019 FINCEN notices: Guidance (to MSBs) and Advisory (to banks)
9. Dec 20, 2019 US Lawmakers Ask IRS for Clarity on Airdrops, Forks
Tax Reporting Requirements of Virtual Currency (IRS Notice 2014-21)

• Notice 2014 -21 describes how existing tax principles apply to transactions using virtual currency (“VC”)
• VC is treated as Property
  • General tax principles applicable to property transactions apply to transactions using VC
  • Fair market value (FMV) of the property is the amount realized
  • Amount received must be measured in U.S. Dollars

• Sale or exchange or use of VC to pay for goods or service has tax consequences that may result in a tax liability.

• Gain or loss on sale of VC is gain or loss from sale of exchanges of profits, treated in a manner similar to sale or exchange of securities.

• Basis of VC received as payment for goods or services is the FMV of the VC in U.S. dollars as of the date of payment or receipt
  • Determined by value listed on an exchange (Which one? Liquidity adjustment?)
• Gains on Holding VC
  • If the FMV of the property or services received in exchange for VC exceeds the taxpayer’s adjusted basis of the VC, the Taxpayer has taxable gain.
  • If the FMV of the property or services received is less than the adjusted basis of the VC, the Taxpayer has a loss.

• Income from exchanging VC for goods or services is FMV of VC on date property was received (in USD).

• Basis = FMV on date currency was received (in USD).

• If FMV of property received exceeds TP’s basis in VC, then TP has taxable gain (or vice versa a loss).

• Character of gain or loss depends on whether VC is a capital asset in the hands of TP.
  • If held as investment property, the gain or loss on sale would be capital in nature.
  • Inventory or other property held mainly for sale to customers in a trade or business is not a capital asset.

- Employers paying VC as remuneration for services constitute wages for employment tax purposes and is subject to Federal tax withholding.

- VC Payments are subject to the same information reporting as other payments (i.e. Forms W-2, 1099, 1042 - Misc., etc.)

- Payments made by VC are subject to back-up withholding rules to the same extent as other payments.
  - Payors must solicit TIN from payees
  - Issue re: Anonymity

- Property Settlement Entities are required to report payments made to merchants to settle payments between merchants and their customers on Form 1099-K if the number of transaction exceeds 200 and the gross amount of payments made to merchant exceeds $20,000.
Rev. Rul. 2019-24

- **Treatment of Hard Forks (split into two or more VC with shared history)**
  - Is this a taxable event?
  - Analogous to Stock Split?
  - New Asset with Zero Basis?

- **October 9, 2019 IRS releases Rev. Rul. 2019-24, 2019-44 IRB 1004, which purports to address the tax treatment of hard forks**
  - Hard forks can be taxed on the full market value of the new cryptocurrency that emerges from the fork.
  - IRS construes new cryptocurrency as “free money” - similar to prizes or treasure troves. Can you throw it back like a home run ball (IR-98-56)?
  - No de minimis exemption for small purchases, e.g., cup of coffee

- **December 20, 2019 US lawmakers ask IRS to clarify crypto tax rules relating to airdrops and hard forks**
Other Unresolved Issues: Tax Reporting Requirements for Cryptocurrency Exchanges

• **Mining Activity**
  - Does the mining of VC produce taxable income? Yes
  - Subject to self-employment tax? Yes (Query whether proof-of-work is the same)
  - Expenses associated with mining activity deductible? Should be

• **Section §1031 - Like Kind Exchanges**
  - Is exchanging VC for VC a Like-Kind Exchange (Pre-2018 Exchanges)?
    - Bullion-type coins vs. numismatic-type coins (compare Rev. Rul. 76-214 and Rev. Rul. 79-143)
    - “... are not used as a circulating medium of exchange, ...”
    - Eliminated for Post-January 1, 2018 Exchanges (Tax Cuts and Jobs Act of 2017)

• **Gains Subject to 3.8% Net Income Tax**
  - Probably Yes
Other Unresolved Issues-
Tax Reporting Requirements for Cryptocurrency Exchanges

- **Initial Coin Offerings (ICO)**
  - Is the raising of funds recognizable in income?
  - Stock offerings v. Sale of goods and services
  - What about offsetting liability?

- **AICPA Proposals for Further Guidance**
  - De minimis exception for small transactions (i.e., $200 – similar to Currency Rule IRC §988 (e)(2))
  - Charity contribution above $5,000 and need for Qualified Appraisal
  - VC’s held by Retirement accounts
  - FBAR (see comments of Carole House, 165 Tax Notes Federal 1201) and Form 8938 Guidance
  - Expensing guidance for mining activity

- **ABA Comments**
Even More Unresolved Issues

- Accounting for Gains and Losses
  - FIFO
  - LIFO
  - Specific Identification (see FAQ 38)

- Wash Sales Rule
  - IRC § 1091 → stock or security?

- Recordkeeping Rules
  - IRC § 6001

- Economic Substance Doctrine

- Lost or Stolen Coins
  - Casualty loss
  - Pre-Tax Cuts and Jobs Act of 2017
  - Post-Tax Cuts and Jobs Act of 2017

A Client with a Cryptocurrency Issue Just Called - What Now?
And... More Unresolved Issues

- **Timing of Gains and Losses**
  - Annual accounting concept

- **Valuation Rules**
  - How do they apply

- **Fees and Costs**
  - Schedule A
    - Pre-Tax Cuts and Jobs Act of 2017
    - Post-Tax Cuts and Jobs Act of 2017
  - Mining

- **Application of Currency Rules IRC § 988**

- **Tax Planning**
  - Expatriation IRC § 877A
  - Moving to Puerto Rico (Bonafide Resident)
Potential Foreign Disclosure Requirements - FBAR

- **Who Must File an FBAR**
  - A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year.

- **Financial Account Definition**
  - A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund.
Potential Foreign Disclosure Requirements - FBAR

- Does holding VC as an Off Exchange Digital Wallet implicate the FBAR rules?
  - Probably not
  - Analogous to holding gold in a safe deposit box
  - Based on Informal Statements of IRS Personnel in 2014 and

- Does holding VC in an Digital Currency Exchange Account implicate the FBAR rules?
  - Perhaps
  - Location of Exchange
  - Domestic v. Foreign Servers
  - Analogous to Financial Institutions
  - FinCen would have interest in knowing; but see comments of Carole House, FinCEN cybersecurity policy specialist, at AICPA National Tax Conference on 11/13/19.

- When in doubt, disclose on FBAR.
Potential Foreign Disclosure Requirements - Form 8938

• Specified foreign financial assets include the following assets
  1. Financial accounts maintained by a foreign financial institution.
  2. Stock or securities issued by someone that is not a U.S. person
  3. Any interest in a foreign entity, and
  4. Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person

• Does VC need to be disclosed on Form 8938?
  • Not clear
  • Unless considered held by a foreign Financial Institution

• When in doubt, disclose on Form 8938
Civil Exam Considerations

- Lack of Information reporting - Form 1099K
- IRS Enforcement Staffing Dedicated to address VC
- Compliance has been Low - 800 to 900 Per Year
- Standard Audit Question Now Asking About Virtual Currency
- IRS Coinbase “John Doe” Summons
- Tax and Compliance Issues Make Reporting Difficult
- Recordkeeping by Exchanges and Holders of VC
Potential Civil Penalties For Non-Compliance

• Fraud penalties imposed under IRC §§ 6651(f) or 6663. Where an underpayment of tax, or a failure to file a tax return, is due to fraud, the taxpayer may be liable for penalties that essentially amount to 75 percent of the unpaid tax.

• An accuracy-related penalty on underpayments imposed under IRC § 6662. Depending upon which component of the accuracy-related penalty is applicable, a taxpayer may be liable for a 20 percent or 40 percent penalty.

• Penalty defenses

A Client with a Cryptocurrency Issue Just Called - What Now?
Additional Civil Penalties for Non-Compliance (cont.)

If cryptocurrency held in a foreign account, additional civil penalties could apply:

- Penalty for failure to file FBAR. The civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign financial account.

- Nonwillful penalty can be significant if imposed per account, per year.

- Penalty for failing to file Form 8938 reporting taxpayer’s interest in certain foreign financial assets. The civil penalty for failing to file each one of these informational returns is $10,000 increasing by $10,000 for each month the failure continues beginning 90 days after the taxpayer is notified, up to a maximum of $50,000 per return.
Possible Criminal Charges for Non-Compliance

Possible criminal charges:

• Attempt to evade or defeat tax/tax evasion (IRC § 7201)
• Willfully filing a false return (IRC § 7206)
• Conspiracy to defraud the government (18 USC § 286)
• Conspiracy to commit offense (18 USC § 371)

A person convicted of tax evasion is subject to a prison term of up to 5 years and a fine.

Willfully filing a false return subjects a person to a prison term of up to three years and a fine.
Criminal Investigations, Prosecutions and Enforcement Measures for Failing to Properly Report Cryptocurrency Transactions

- CI Contract with Chainalysis, Inc. (2017)
- Leads and Development from Examination
- Results of Coinbase John Doe Summons Enforcement
- Virtual Currency Suspicious Activity Reports (SARs)
- Joint Chiefs of Global Tax Enforcement (J5)
A Client with a Cryptocurrency Issue Just Called - What Now?

Criminal Investigations, Prosecutions and Enforcement Measures for Failing to Properly Report Cryptocurrency Transactions

| Section C  
Statement of Work  
Investigative License  
July 27, 2015 |
|-----------------|

**C.1 INTRODUCTION**

In support of its mission, Internal Revenue Service (IRS) Criminal Investigation (CI) needs to obtain access to the commercial database World Check, which will give us immediate access to overseas data from 256 different countries where World Check analysts are gathering facts on companies, business individuals, local attorneys and more. This is the viable source for this information.

**C.2 OBJECTIVE**

The purpose of this acquisition is to get access to the contractor reactor to help us trace the movement of money through the bitcoin economy. This is necessary to identify and obtain evidence on individuals using bitcoin to either launder money or conceal income as part of tax fraud or other Federal crimes.
Criminal Investigations, Prosecutions and Enforcement Measures for Failing to Properly Report Cryptocurrency Transactions

Chainalysis Inc. is the sole manufacturer of the product Reactor and there are no resellers. It is the first and only real time investigation tool for tracing Bitcoin transactions. Leveraging the largest proprietary database of meta-data associated with Bitcoin transactions, investigators are able to gain greater insights over the source of funds of particular Bitcoin transactions and follow the money from hacks, ransomware and other malicious activity.

Our real time infrastructure allows the user to create custom clusters of Bitcoin addresses to assist in spotting transaction patterns, interactions with other entities and simplify an investigation so that it can be presented as court evidence. The flexibility of calculating everything in real time means that alerts and risk scores can be calculated adding additional monitoring and investigative capabilities. Even entities that have not been labelled in our vast database can inherit some information from whom that entity has transacted with.
Issues to Spot for Badges of Fraud

• **Use of “mixers” or “tumblers”**
  - Software or services that let VC users mix their coins with other users in order to preserve privacy
  - Some services have been banned in other countries (see Dutch Financial Intelligence and Investigation Service shutting down Bestmixer.io)

• “Off-chain” transactions

• Others beyond our comprehension?
Per Se Willfulness For Failing to Report?

<table>
<thead>
<tr>
<th>SCHEDULE 1</th>
<th>Additional Income and Adjustments to Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Form 1040 or 1040-SR)</td>
<td>▶ Attach to Form 1040 or 1040-SR.</td>
</tr>
<tr>
<td>Department of the Treasury</td>
<td>▶ Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.</td>
</tr>
<tr>
<td>Internal Revenue Service</td>
<td></td>
</tr>
<tr>
<td>Name(s) shown on Form 1040 or 1040-SR</td>
<td>Your social security number</td>
</tr>
</tbody>
</table>

**At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?**

- **Part I: Additional Income**
  - 1. Taxable refunds, credits, or offsets or state and local income taxes
  - 2a. Alimony received
  - b. Date of original divorce or separation agreement (see instructions)

**Yes [ ] No [ ]**
IRS Crypto Investigation Emphasizes Grand Jury Subpoena

- IRS Criminal Investigation division special agents investigating taxpayers who may have cryptocurrency assets should consider using grand jury subpoenas to look at the subject’s download history, according to CI training materials.

- CI has made clear that it is looking for criminal tax cases involving cryptocurrency.

- Notifying investigation subjects about obtaining information on their cryptocurrency use may interfere with later attempts to seize their cryptocurrency balances.

- Grand jury subpoenas for conventional financial account information may also yield information about cryptocurrency use. Bank and credit card records may show transactions related to cryptocurrencies or third-party exchanges that deal in cryptocurrencies.

- Bitcoin Block Explorer, a publicly available website, can be combined with bitcoin address information to discover details like transaction times and locations and other addresses to help find the subject of the investigation.
The Use of the IRS Voluntary Disclosure Policy to Get into Compliance and the Availability of “Qualified Amended Returns” to Avoid Penalties

- History of Voluntary Disclosures (“VDs”)  
- Domestic VDs  
- Foreign VDs  
- Effectiveness of VDs  
- Qualified Amended Returns and Penalty Relief  
- Applicable Penalties  
- Still time to correct

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