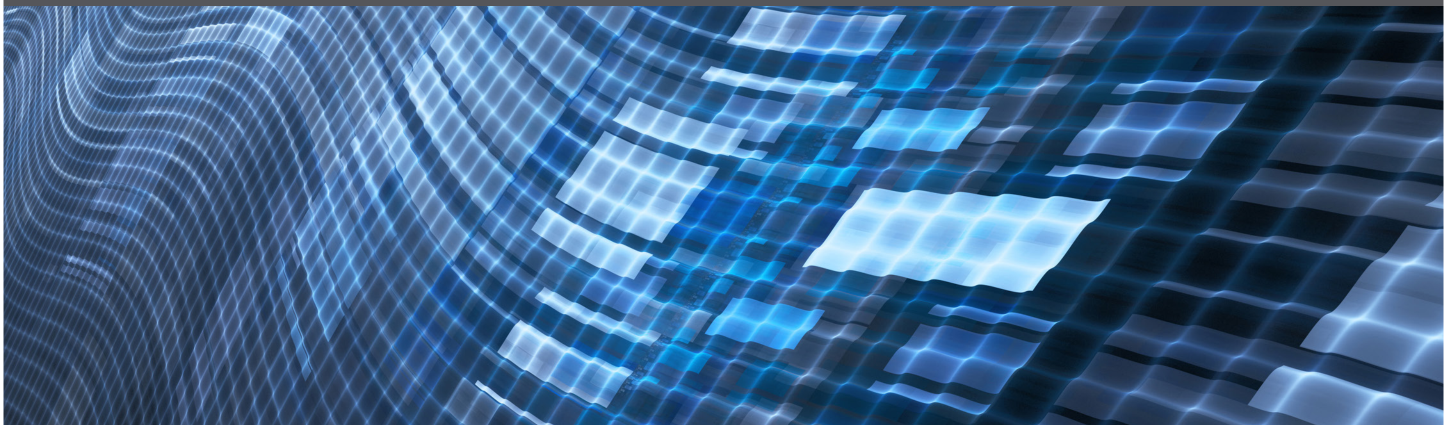
BLANKROME

Blockchain Technology & Digital Currencies



MARCH 2018 • NO. 1

# IRS Increases Focus on Criminal Prosecution of Cryptocurrency Tax Evasion: What You Need to Know before Tax Day

*In 2017, the world witnessed virtual currency investors become millionaires seemingly overnight with cryptocurrencies, such as Bitcoin, climbing from $830 to $19,300.[1] As tax day approaches (April 17, 2018), cryptocurrency investors should be aware of their tax liabilities.*

## PEOPLE ARE UNDERREPORTING CRYPTOCURRENCY AND THE IRS HAS NOTICED

Out of 120 million tax returns between 2013 and 2015, less than 900 taxpayers reported cryptocurrency gains.[2]

On November 17, 2016, the IRS issued a summons to Coinbase, the largest cryptocurrency exchange in the United States, seeking information related to cryptocurrency transactions.[3] Coinbase resisted the summons and litigated the dispute in the Northern District of California. A year after the summons was issued, Coinbase was ordered to produce certain documents for all transactions valued at least $20,000 between 2013 and 2015.[4]

It is estimated that the information of approximately 14,000 customers out of the 5.9 million Coinbase[5] users will be produced to the IRS under this order.[6]

In addition, the IRS has assembled a specialized task force in the Criminal Investigation Division to target individuals who attempt to evade paying taxes on their cryptocurrency earnings.[7] With the help of other criminal agents, both foreign and domestic, the cryptocurrency task force is using prior experience gained in tracking cryptocurrency by working on hundreds of identity-theft cases to build cases against cryptocurrency tax evaders.[8]

Early data for 2017 tax returns (representing approximately 13 percent of 2017 tax returns) suggests that taxpayers are still underreporting. Out of the estimated seven percent of Americans who own cryptocurrency, only .04 percent of these tax returns report cryptocurrency gains and losses.[9]

## UNCLE SAM IS ENTITLED TO A PORTION OF YOUR CRYPTOCURRENCY GAINS

Although the IRS has offered little guidance as to the intricacies of various cryptocurrency tax requirements, one thing is clear: the IRS treats cryptocurrency as property for tax purposes. In 2014, the IRS issued Notice 2014-21,[10] confirming virtual currencies, such as Bitcoin, that can be converted into traditional currencies are subject to tax laws.

This means that the following transactions may result in capital gains or losses:[11]

- Cryptocurrency investments with a duration over a year
- Trading cryptocurrencies
- Exchanging tokens
- Spending cryptocurrency
- Air drops when sold

BLANKROME



With the following transactions likely constituting ordinary income:[12]

- Cryptocurrency investments with a duration under a year
- Receiving payment in crypto
- Air drops when received
- Mining coins
- Initial coin offerings

## CAN TAXPAYERS DEFER THEIR CRYPTOCURRENCY GAINS?

Previous law provided for the deferral of gain on "like-kind" exchanges (via a transferred tax basis) under Section 1031 of the Internal Revenue Code for a variety of assets. This rule allowed for the deferral of gain on real estate, tangible personal property such as artwork and livestock, and certain intangible property. While Section 1031 specifically exclude stocks, bonds, notes, and indebtedness, there is no mention of virtual currency.[13]

Whether crypto-to-crypto trades can be treated as like-kind exchanges for cryptocurrency transactions in 2017 is debatable as the IRS has offered little guidance. Taxpayers who intend to report their cryptocurrency gains for year 2017 under Section 1031 should consult a knowledgeable tax professional.

The recently-passed tax bill significantly reduces the scope of Section 1031 by eliminating the deferral of gain on all like-kind exchanges except for real property.[14] Thus, all cryptocurrency transactions after December 31, 2017 will certainly not qualify as a tax-deferred transactions.

## THE BOTTOM LINE

The IRS has made clear that cryptocurrency gains must be reported and taxpayers will face penalties for noncompliance. Taxpayers should be cautious in reporting their tax liabilities for cryptocurrencies and may want to either consider prior tax treatment of similar investments or consulting a tax professional.

**For more information, please contact:**

**Michelle Ann Gitlitz**
**212.885.5068 | mgitlitz@blankrome.com**

**Carlos F. Ortiz**
**609.750.2641 | cortiz@blankrome.com**

**Richard Chou**
**424.239.3477 | rchou@blankrome.com**

**D. Morgan Barry**
**212.885.5499 | dmbarry@blankrome.com**

1. Nellie Bowles, *Everyone is Getting Hilariously Rich and You're Not,* N.Y. TIMES, (Jan. 13, 2018).
2. *U.S. v. Coinbase, Inc.,* No. 17-CV-01431-JSC, 2017 WL 5890052, at *8–9 (N.D. Cal. Nov. 28, 2017).
3. Joseph A Riley et al., *U.S. v. Coinbase: Virtual Currency Holders Not Outside the IRS's Reach,* LEXOLOGY (Dec. 11, 2017).
4. *Coinbase,* 2017 WL 5890052, at *8–9 (ordering Coinbase to provide documentation for accounts with "at least the equivalent of $20,000 in any one transaction type (buy, sell, send, or receive) in any one year during the 2013 to 2015 period").
5. Investors who use platforms other than Coinbase should not feel impervious to the IRS as it is likely other cryptocurrency platforms are receiving similar demands following the Coinbase victory.
6. *Riley, U.S. v. Coinbase: Virtual Currency Holders Not Outside the IRS's Reach,* LEXOLOGY.
7. Fox Rothschild LLP, *IRS-Criminal Investigation Ramps up Scrutiny on Cryptocurrency Transactions,* JDSUPRA, (Feb. 15, 2018).
8. David Voreacos, *IRS Cops Are Scouring Crypto Accounts to Build Tax Evasion Cases,* BLOOMBERG (Feb. 8, 2018).
9. Jen Wieczner, *Bitcoin Investors Aren't Paying Their Cryptocurrency Taxes,* FORTUNE (Feb. 13, 2018).
10. Internal Revenue Service, *Internal Revenue Bulletin: 2014-16, IRS Virtual Currency Guidance* (Apr. 14, 2014). A virtual currency subject to taxes is "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value."
11. Vincenzo Villamena, *Cryptocurrency and Taxes: What you Need to Know,* CNBC (Jan. 30, 2018).
12. *Id.*
13. 26 U.S.C. § 1031.
14. Tyson Cross, *The Truth about Cryptocurrency and Like-Kind Exchanges,* FORBES (Feb. 19, 2018).