

[Journal of Tax Practice and Procedure, The IRS Ramps up Cryptocurrency Enforcement, \(Jun. 22, 2021\)](#)

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Caroline Rule and **Daniel Q. Flesch** examine IRS's successful John Doe Summons efforts and escalating efforts to unveil identities.

At a Federal Bar Association conference in March of this year, Damon Rowe—Director of the Office of Fraud Enforcement at the IRS—announced a new initiative. Operation Hidden Treasure ^[1] consists of a special joint-effort to track down unreported cryptocurrency. The campaign combines the skills of the IRS's civil fraud unit with the muscle and savvy of its criminal investigation division. The IRS plans to train its employees on the complexities of the world of virtual currency (*i.e.*, cryptocurrency), with agents working alongside ^[2] representatives of the European Union Agency for Law Enforcement Cooperation (Europol), in order to coordinate a response that accounts for the international nature of border-hopping virtual assets.

A month after the IRS announced its new program, the Service's attack on cryptocurrency tax or reporting evasion advanced another step. In April, a court in the District of Massachusetts gave the IRS the go-ahead to issue a John Doe summons—a summons seeking information about an ascertainable class of unknown individuals who may have failed to comply with the internal revenue law ^[3]—to Boston-based Circle International Financial Inc. ("Circle"), a company which specializes in payments technology related to cryptocurrencies. ^[4] A month later, in May, a court in the Northern District of California authorized the IRS to serve a John Doe summons on Payward Ventures Inc. d/b/a Kraken ("Kraken"), a cryptocurrency exchange and bank whose headquarters are in San Francisco. ^[5]

The recent whirlwind of coast-to-coast activity in the realm of cryptocurrency enforcement did not emerge out of the blue; the IRS has been mulling ways to attack digital currency tax evasion since 2014, when it released [Notice 2014-21](#). Over the past decade, the Service has been taking notes and laying traps, and it is now primed to go after cryptocurrency tax evaders.

Notice 2014-21 and Forms 1040, 433-A, and 433-B

In March of 2014, the IRS issued Notice 2014-21. The Notice began with a brief definition of virtual currencies, before officially classifying cryptocurrency for the first time: "for federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency." As with any other piece of property, taxpayers selling or exchanging digital currency must report gains or losses in accordance with their initial basis in the asset.

The IRS had therefore brought cryptocurrency into the realm of tax, but several years would pass before the Service decided to supplement its vague and general notice with specific, point blank queries on tax returns and forms. In 2019, the IRS added a series of questions to Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, and to Form 433-B, *Collection Information Statement for Businesses*. ^[6] Both Forms now request the name of any digital currency that the taxpayer owns, the identity of the exchange

or wallet holding it, the email address linked to the virtual account, the location of the asset, and the amount held as of the date that the taxpayer fills out the form. ^[7] The IRS has untied its hands so it can now go after virtual assets in collection proceedings.

More significantly, in 2020, the IRS added a similar yes-or-no question to individual income tax returns, Forms 1040—“At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?” ^[8]—thereby cementing its focus on tax reporting of cryptocurrency transactions rather than merely on collection efforts.

The changes to Forms 1040, 433-A, and 433-B allow the IRS to enforce tax reporting, to gather information on cryptocurrency holdings, to use virtual currency to calculate collection potential, and to collect digital assets from taxpayers. These changes also lay a trap for virtual currency tax evaders. One tax commentator has pointed out that [Code Sec. 7206\(1\)](#), which relates to perjury, covers any false representation made on a “return, statement, or other document,” including Forms 433-A and 433-B. ^[9] [Code Sec. 7206\(5\)\(b\)](#), meanwhile, makes it a felony to conceal “property”—including digital currency—in connection with an offer in compromise. Another commentator ominously summed up the [Code Sec. 7206](#) risk: with the new questions on the Forms 1040, 433-A, and 433-B “the IRS is just gathering the data, changing the forms to expressly say you did or didn’t [hold virtual assets], and setting the trap, so in the coming years, the hammer can come down.” ^[10]

The Coinbase John Doe Summons

The IRS hasn’t just been tweaking its forms. Since 2014, the Service has aggressively used John Doe summonses to obtain client information from cryptocurrency exchanges, banks, and technology companies. The IRS’s 2017 battle with Coinbase Global Inc. (“Coinbase”), the largest cryptocurrency exchange in the United States, helped define the issues surrounding the use of John Doe summonses in connection with virtual currency enforcement.

In November 2016, a court in the Northern District of California authorized the IRS to send Coinbase a John Doe summons that included nine broad categories of information. ^[11] A month later, a Coinbase customer challenged the enforcement of the summons on the grounds that the IRS had defined an improperly large and imprecise class of customers. ^[12] In January of 2017, Coinbase filed its own petition to intervene in the court proceeding, ^[13] and three John Does subsequently filed intervention motions in May. ^[14]

The breadth of the summons sparked protest from all of the intervenors. In their motion to intervene, ^[15] John Does 1 and 2 pointed out that the summons used the vague and overly general argument that “the IRS is conducting an investigation to determine the correct income tax liability of every U.S. citizen who conducted virtual currency transactions over a three-year period” to justify requiring Coinbase to “identify over 1 million American citizens that [sic] have transacted in virtual currency and to provide every piece of information in its possession regarding those clients, including data concerning every single transaction over a 3-year period.” ^[16] The John Does asked the court to imagine the outrage that would explode from all quarters if the IRS had used the “claim that is [sic] investigating the correct income tax liability of every U.S. citizen who has transacted in cash to justify the issuance of a summons to every single bank for all of its customers’ ATM cash withdrawal activity.” ^[17] John Does 1 and 2 also stressed that “the IRS Summons does not contain any dollar value or transaction thresholds.” ^[18] The IRS was recklessly acting as if it had “boundless summons power.” ^[19]

The court agreed with John Does 1 and 2. In its order granting their intervention, the court echoed their motion’s banking analogy, and scoffed at the IRS’s vague argument that “there seems to be a substantial gap between the number of people transacting in virtual currency (for which tax consequences might attach) and those that are reporting such transactions.” ^[20] “Under that reasoning,” the court explained, “the IRS could request bank records for every United States customer from every bank branch in the United States because it is well known that tax liabilities in general are under reported and such records might turn up tax liabilities.” ^[21]

Not to be deterred, the IRS submitted a narrowed summons, which requested more particular information, and which took the John Does' advice to add "dollar value or transaction thresholds"; the new summons requested accounts "with at least the equivalent of \$20,000 in any one transaction type ... in any one year during the 2013–2015 period." [22] Instead of making a vague claim about a "substantial gap," the IRS subsequently presented hard statistics showing the discrepancy between the overall number of taxpayers who filed electronic returns (83–84%) and who held digital property assets, and the number who had e-filed Forms 8949, *Sales and Other Dispositions of Capital Assets*, which includes a field for reporting "property" transactions. [23] As an article in the *Journal of Accountancy* summarizes the IRS's analysis, only "between 800 and 900 persons" had filed Forms 8949. [24] Coinbase refused to comply with the narrowed summons, but in November 2017 the court ordered Coinbase to turn over its records. [25]

The Coinbase saga caused outcry regarding IRS overreach in its issuance of summonses. As one tax expert explains, Congress responded by amending [Code Sec. 7609\(f\)](#): "as part of the Taxpayer First Act, in 2019, Congress codified the approach taken by the Northern District, amending the John Doe Summons statute to require that any summons be 'narrowly tailored' to identify non-compliance." [26]

The Circle and Kraken John Doe Summonses

But if Congress and the public learned from the Coinbase battle, so did the IRS. The IRS used its experience from the Coinbase case to skillfully navigate the hurdles that might have blocked the John Doe summons that it successfully issued to Kraken this May. The Service has also cited the incompleteness of the records it received from Coinbase to justify the breadth of the requests that it made in the Kraken summons. [27]

The IRS issued almost identical summonses to Circle and Kraken. But, while the court in the District of Massachusetts gave the IRS no trouble, the Northern District of California proved less amenable. Citing the new "narrowly tailored" requirement, the court issued an Order to Show Cause requiring the IRS to demonstrate that its summons contained sufficiently specific document requests. [28]

In response to the court's Order to Show Cause, the IRS deftly reframed and refined its summons. The revised summons requested narrower categories of documents, and the IRS had already mirrored its second Coinbase summons by including in the first version of the summons a \$20,000 dollar threshold, this time for transactions that took place between 2016 and 2020. [29]

In some areas, however, the Service declined to whittle down the scope of its document requests. The IRS explained that basic identifying information might not, on its own, provide enough data to track down potentially noncompliant John Does; taxpayers sometimes used aliases and fictitious entities, fake addresses or isolated P.O. boxes. [30] And, the IRS continued, the Service was interested in precisely those taxpayers whom it would not be able to identify from basic information alone. The taxpayers who went to the trouble of creating false entities or of using *noms de guerre* were exactly the ones "more likely to evade their taxes." [31]

Once again, the IRS drew on and acknowledged "the benefit of [its] experience with Coinbase." [32] In defending its broad requests, the IRS pointed out that the four data points—name, date of birth, taxpayer identification number, and physical address—that it had requested from Coinbase had proven insufficient. Coinbase had been unable to provide TINs for over 1,300 customers, and had been missing information related to the real names, addresses, and DOBs of over 1,800 more. Even after Coinbase made a supplemental production to the IRS, and after the IRS had added its own data along with any information it could cull from other sources, the Service was still unable to identify over 750 customers with "cryptocurrency proceeds that exceeded \$100,000,000." [33] From its experience with Coinbase, the IRS also "learned that telephone and email information is used more frequently in the cryptocurrency space than names or physical addresses." [34]

The IRS flagged the shortcomings of the Coinbase summons in order to defend its more robust Kraken summons, which included, along with the four basic data points, fifth and sixth categories for phone numbers and

emails. ^[35] Over the course of a 10-page explanation at the close of its brief, the IRS carefully explained—with citations to the Coinbase case and to Kraken’s own specific procedures and protocols—why it would need each particular piece of information, including user profiles, histories of changes to user profiles, and other records. ^[36] One tax expert describes how the IRS demonstrated its “ability to learn from past mistakes and nimbly make adjustments” in response to the Order to Show Cause. ^[37] The court agreed, ^[38] and the Kraken summons, with the aid of the knowledge and data gained from the Coinbase one, jumped over its first legal obstacle—court authorization—and is now hurtling toward Kraken.

Constitutional Problems with John Doe Summonses

As the Coinbase case shows, issuing a summons is a different matter from enforcing it. Kraken may file a motion to intervene in the court proceeding—a route that the court seems to have left open by noting, in its order granting the issuance of the summons, that “any further disputes as to the scope of the summons would benefit from adversarial briefing.” ^[39] The court in the Coinbase case, meanwhile, stressed that if a John Doe learns of a summons, that person may have a “protectable interest in the *enforcement* proceeding,” even if they do not have grounds to challenge the initial issuance of the summons. ^[40]

A more difficult question arises with respect to situations where a John Doe never learns of the existence of a summons, or where a John Doe learns too late. Kraken is not required to provide notice to its customers, many of whom might have no idea that the IRS is planning to seize their information. A former Coinbase John Doe, James Harper, filed suit in the District of New Hampshire, arguing that the lack of notice violated his right to due process and that the IRS had infringed on his fourth amendment privacy rights. ^[41] The court ruled that the Anti-Injunction Act prevented Harper from suing. The case is currently on appeal. ^[42]

Regardless of the outcome of the Harper case, or of the ultimate success or failure of the IRS’s enforcement of the Circle and Kraken summonses, taxpayers holding noncompliant virtual assets should read the writing on the wall. The IRS has expanded its cryptocurrency capabilities with remarkable speed and versatility. In the seven years since [Notice 2014-21](#) officially classified digital currency as property subject to general tax rules, the Service has required cryptocurrency information to be disclosed on significant tax forms, including individual income tax returns; announced operations with international scope; and honed the John Doe summons into a potent weapon. Noncompliant taxpayers will no longer be able to hide behind aliases, fictitious entities, and P.O. boxes. These taxpayers should perhaps consider making a voluntary disclosure before the IRS learns their identities; either way, their virtual treasure probably won’t stay hidden much longer.

Footnotes

- * Caroline Rule represents clients in civil and criminal tax controversies. She is Chairman of the Subcommittee on Tax Crimes, Criminal Litigation Committee, ABA Litigation Section. She is also a member of the New York Council of Defense Lawyers; the Criminal Advocacy Committee and the Mass Incarceration Task Force of the New York City Bar Association; and the Federal Bar Council Committee on Sentencing Reform and Alternatives to Incarceration. She is also a Master of the Federal Bar Council Inn of Court.
- 1 G. Moore, *Operation Hidden Treasure Is Here. If You Have Unreported Crypto, Get Legal Advice*, FORBES, March 6, 2021, available at www.forbes.com/sites/irswatch/2021/03/06/operation-hidden-treasure-is-here-if-you-have-unreported-crypto-its-time-to-get-legal-advice/?sh=3d5e10f39c95.
- 2 D. Kuhn, *IRS Initiates “Operation Hidden Treasure” to Root Out Unreported Crypto Income*, NASDAQ, March 7, 2021, available at www.nasdaq.com/articles/irs-initiates-operation-hidden-treasure-to-root-out-unreported-crypto-income-2021-03-07.

- 3 See [Code Sec. 7609\(f\)](#), requiring court approval before the IRS issues a summons when:
 - (1)The summons relates to the investigation of [an] ascertainable group or class of persons,
 - (2)There is a reasonable basis for believing that such ... group or class of persons may fail or may have failed to comply with any provision of any internal revenue law, and
 - (3)The information sought to be obtained from the examination of the records or testimony (and the identity of the ... persons with respect to whose liability the summons is issued) is not readily available from other sources.A John Doe summons must be “narrowly tailored to information that pertains to the failure (or potential failure) of the ... group or class of persons ... to comply with one or more [identified] provisions of the internal revenue law[.]” *Id.*
- 4 See Department of Justice press release, *Court Authorizes Service of John Doe Summons Seeking Identities of U.S. Taxpayers Who Have Used Cryptocurrency* (Apr. 1, 2010), available at www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-0. The summons includes Circle’s predecessor, subsidiaries, divisions, and affiliates, including Poloniex LLC.
- 5 See Department of Justice press release, *Court Authorizes Service of John Doe Summons Seeking Identities of U.S. Taxpayers Who Have Used Cryptocurrency* (May 5, 2021), available at www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1.
- 6 In 2019, the IRS issued Rev. Rul. 2019-24, which provided further guidance regarding the treatment of digital assets, specifically when a taxpayer receives income because of a cryptocurrency “hard fork” resulting in a new cryptocurrency.
- 7 Among other uncertainties regarding the IRS’s position on various cryptocurrency issues, one question that worries some tax experts relates to the fact that the volatility of many digital currencies may cause amounts that were accurate when the taxpayer reported them to have fluctuated wildly by the time the IRS comes to collect. See N.J. Richman, *Collection Question Might Lead to Outdated Answers on Crypto*, TAX NOTES FEDERAL (Mar. 16, 2020), available at www.taxnotes.com/tax-notes-federal/collections/collection-question-might-lead-outdated-answers-crypto/2020/03/16/2c8q5. The drastic monthly changes in the values of some currencies could cause the IRS to calculate highly inaccurate reasonable collection potentials by relying on outdated information derived from Forms 433-A and 433-B.
- 8 2020 Form 1040; the return poses the question in the space directly below the address and identifying information section, and before the numbered lines begin.
- 9 M. Roberts, *Can You Go to Jail for Failing to Disclose Virtual Currency on a Tax Return or as Part of an Offer for a Collection Alternative?*, FREEMAN LAW, December 16, 2020, available at <https://freemanlaw.com/can-you-go-to-jail-for-failing-to-disclose-virtual-currency-on-a-tax-return-or-as-part-of-an-offer-for-a-collection-alternative/>.
- 10 J. Herron, *IRS Is “Setting the Trap” for Bitcoin and Virtual Currency Investors on 2020 Tax Form*, YAHOO FINANCE, December 15, 2020 (quoting Ryan Losi), available at https://finance.yahoo.com/news/irs-bitcoin-and-virtual-currency-tax-form-193503386.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAFFMKOhzEo7rt6S0fwmjYUuKD7O23O1I2wq6mqCnLDv_wTNY0_7ecfWB2b4rHwucY_hbS6bo8jURWbRPICpkUJkXolzQGeURIFasAJUvdBc0BHkqw5
- 11 See Department of Justice press release, *Court Authorizes Service of John Doe Summons Seeking the Identities of U.S. Taxpayers Who Have Used Virtual Currency* (Nov. 30, 2016), available at www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used.
- 12 See 16-cv-06658-JSC (N.D. Ca.), Docket No. 9.
- 13 See 16-cv-06658-JSC (N.D. Ca.), Docket No. 19.
- 14 See 17-cv-01431-JSC (N.D. Ca.), Docket Nos. 10 and 17.
- 15 See 17-cv-01431-JSC (N.D. Ca.), Docket No. 10.
- 16 *Id.*

- 17 *Id.*
- 18 *Id.*
- 19 *Id.*
- 20 See 17-cv-01431-JSC (N.D. Ca.), Docket No. 40.
- 21 *Id.*
- 22 See 17-cv-01431-JSC (N.D. Ca.), Docket No. 37. The IRS actually submitted the narrowed summons prior to the court's order on the motion to intervene, but the parties agreed that the court should only consider the initial summons when ruling on the motion.
- 23 See 17-cv-01431-JSC (N.D. Ca.), Docket No. 65.
- 24 M. Aquilio, *Court Grants Summons of Coinbase Records*, J. ACCOUNTANCY (Mar. 1, 2018), available at www.journalofaccountancy.com/issues/2018/mar/irs-summons-of-coinbase-records.html.
- 25 See 17-cv-01431-JSC (N.D. Ca.), Docket No. 78.
- 26 G. Moore, *IRS Lawsuit to Get Crypto Account Holder Information Signals It Is Time for Kraken Crypto Account Holders to Get Taxes in Order*, FORBES, March 31, 2021 (quoting John Colvin), available at www.forbes.com/sites/irswatch/2021/03/31/irs-lawsuit-to-get-crypto-account-holder-information-signals-it-is-time-for-kraken-crypto-account-holders-to-get-taxes-in-order/?sh=52a5431f7e82.
- 27 See 21-cv-02201-JCS (N.D. Ca.), Docket No. 8.
- 28 See 21-cv-02201-JCS (N.D. Ca.), Docket No. 6.
- 29 See 21-cv-02201-JCS (N.D. Ca.), Docket Nos. 1 and 8.
- 30 *Id.*
- 31 *Id.*
- 32 *Id.*
- 33 *Id.*
- 34 *Id.*
- 35 *Id.*
- 36 *Id.*
- 37 G. Moore, *Release the Kraken, District Court Orders. All Crypto Investors Should Pay Attention*, FORBES, May 13, 2021, available at www.forbes.com/sites/irswatch/2021/05/13/release-the-kraken-district-court-orders--all-crypto-investors-should-pay-attention/?sh=29d23fb17356.
- 38 See 21-cv-02201-JCS (N.D. Ca.), Docket No. 9.
- 39 *Id.*
- 40 See 17-cv-01431-JSC (N.D. Ca.), Docket No. 40 (emphasis in original).
- 41 See 20-cv-00771 (D.N.H.), Docket No. 3. See also A. Bagchi & A. Versprille, *Crypto Crackdown Drives "John Doe" Record Demands from IRS*, BLOOMBERG TAX: DAILY TAX REPORT, May 4, 2021, available at <https://news.bloombergtax.com/daily-tax-report/crypto-records-demands-fit-into-irs-tax-evasion-stopping-efforts>.
- 42 See 20-cv-00771 (D.N.H.), Docket No. 17. See also A. Bagchi, *Crypto User Appeals Dismissal of Suit Over IRS Records Grab (1)*, BLOOMBERG TAX: DAILY TAX REPORT, April 20, 2021, available at https://essential.bna.com/login/signin?msg=deny&url=https%3A%2F%2Fwsauth.bna.com%2Fwsauth%2Fbltxauth%3Ftarget%3Dhttps%253A%252F%252Fwww.bloomberglaw.com%252Fproduct%252Ftax%252Fcitation%252FBNA%2525200000178d240dc35af7fd36c18e20002%253Fbna_news_filter%253Dtrue%26v%3D0.1157.0&authenDec=-203.