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Digital Currency

Taxation, Enforcement, and the John Doe Summons

By Michael Sardar

Several years ago, the IRS started its successful takedown of secret Swiss banking with the use of a John Doe summons. Currently, it is trying to replicate that success by using a John Doe summons to uncover the identities of taxpayers using Coinbase, a digital currency exchange used to buy and sell digital currencies such as Bitcoin, Ethereum, and Litecoin.

Status of Digital Currency

In March 2014, the IRS released Notice 2014-21, which stated that digital currency would not be treated as currency, but instead as property. Thus, the receipt of virtual currency as payment for goods or services must be included in gross income. For such purposes, the fair market value of the digital currency received, as measured in U.S. dollars on the date of receipt, is included in gross income. Similarly, digital currency that is held and then sold at a gain is subject to either long- or short-term capital gains tax.

A taxpayer who holds digital currency not as a capital asset, but for sale in a trade or business, is subject to ordinary gain or loss upon sale. Furthermore, a taxpayer that "mines" digital currency recognizes income upon receipt of that currency equal to the fair market value of the currency on that date. Such income may also be subject to self-employment tax.

Bitcoin, the most popular digital currency, has a market value of over $71 billion (as of August 14, 2017), with between 250,000 and 300,000 daily transactions. Because digital currencies generally allow for varying levels of anonymity, they can present an opportunity for tax evasion. A recent Treasury Inspector General for Tax Administration (TIGTA) report noted that digital currency presents a "greater possibility" of "use in illegal transactions" and recommended that the IRS do more to ensure compliance with tax and reporting obligations.

Despite these figures, in each year from 2013 to 2015, fewer than 900 individual taxpayers reported a capital gains transaction related to Bitcoin. The implication is clear: taxable transactions related to digital currencies are not being fully reported.

John Doe Summons to Coinbase

In December 2016, the IRS issued a John Doe summons to Coinbase, effectively seeking the account information for all of its U.S. customers. In seeking issuance of the summons, the government asserted that "there is a reasonable basis for believing that such group or class of person has failed or may have failed to comply" with the tax laws. Coinbase failed to comply with the summons, and the IRS recently moved to enforce the summons. Litigation is ongoing and, as of this writing, has not been resolved.

Under Internal Revenue Code (IRC) section 7602, the IRS is authorized to issue summonses and seek enforcement in the courts if the party upon whom the summons was issued fails to comply. To obtain court enforcement, the IRS must make a prima facie showing of the following:

- The summons relates to an investigation being conducted for a legitimate purpose.
- The information summoned may be relevant to the investigation.
- The information sought is not already within the IRS's possession.
- The IRS has complied with the administrative steps set forth in the IRC.

Once the IRS had made this showing, the burden shifts to the party challenging the summons to set forth reasoning as to why the summons should not be enforced.

These requirements apply when the IRS is seeking enforcement of an ordinary summons. A John Doe summons, however, is issued to a third party and seeks information regarding a taxpayer or class of taxpayers whose identities are unknown. Because of the potential for a John Doe summons to be used in a fishing expedition, there are additional safeguards applicable. Pursuant to IRC section 7609(f), prior to issuing a John Doe summons, the IRS must, in an ex parte application, demonstrate the following to a district court:

- The investigation from which the summons arises is of a particular person or an ascertainable group or class of persons.
- There is a reasonable basis to believe that such person or group may fail, or may have failed, to comply with the tax laws.
- The information sought and the identity of the person or person at issue is not readily available from other sources.

The party upon whom a John Doe summons is issued has no chance to contest the summons prior to its issuance; rather, that party must fail to comply and await the IRS's enforcement action in order to seek review before a court. Initially, the unidentified individuals whose information is sought by a John Doe summons may not be aware of the summons (despite a mechanism that requires the summoned third party to inform those whose tax liability is at issue if the third party does not comply with the summons). Furthermore, challenging the summons would likely lead to

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the target identifying himself as such, which a target is likely unwilling to do.

Nonetheless, in the recent Coinbase case, several John Does have come forward seeking to intervene in the litigation on an anonymous basis; whether they will be allowed to do so is not yet clear. Assuming that they can move forward with their challenge, both they and Coinbase will seek to demonstrate to the court that the John Doe summons is unenforceable. As a preliminary matter, neither Coinbase nor the John Does can challenge the summons on the basis that the IRS has not abided by IRC section 7609(f), as compliance is assumed since issuance of the summons was allowed by the court in the first place. Rather, any challenge to the Coinbase summons will need to show that the summons is improper under the general rules applicable to all IRS summonses or that it seeks information or records protected by privilege.

Those with unreported virtual currency income should strongly consider seeking advice on coming forward to the IRS, becoming compliant, and correcting past noncompliance.

Challenging an IRS Summons

Under the plain language of the statute that allows for the issuance of an IRS summons, such summons power is limited to information that is "relevant and material" to the legitimate purpose for which the summons was issued. In the Coinbase summons, the IRS is effectively seeking all of Coinbase's information regarding all of its U.S. customers. While the relevant and material standard has been broadly construed to allow for very broad summonses, in the context of a third-party summons, courts look more carefully at whether a summons does in fact seek relevant and material information. The summons in Coinbase is intended to elicit information regarding users who have not complied with the Internal Revenue Laws, not *all* Coinbase users (potentially millions of users), which is what the Summons arguably seeks. In addition, because of the wide scope of the summons, it is not clear if the summons actually relates to a legitimate investigation of a taxpayer or group of taxpayers. The information sought is potentially so voluminous that its sheer size may make it unusable. These aspects of the summons and the related argument that it is overbroad may be avenues of challenge.

A summons can also be challenged if it is issued for an improper purpose or in bad faith. For example, a taxpayer may contend that a summons was issued for the purpose of gaining leverage against the taxpayer in a different, unrelated matter. Where the taxpayer can point to specific facts or circumstances that raise the possibility that the IRS is acting with such bad faith, the taxpayer can seek a hearing in advance of complying with the summons to determine if such bad faith rises to a level that would require the court to quash the summons.

An offshoot of the improper purpose doctrine, which has since been made part of the summons statute, prevents the IRS from improperly using the summons process to gather information after it has already referred a case to the Department of Justice (DOJ) for criminal prosecution. This restriction, however, is limited, as each taxable period is treated separately. Thus, even if a taxpayer has been referred to the DOJ for criminal prosecution with respect to one tax year, the IRS can use its summons power with respect to other years.

More generally, a taxpayer can challenge a summons to the extent it seeks privileged documents or information. Records or information that are covered by attorney-client privilege or Fifth Amendment privilege are protected from disclosure, even in the face of an IRS summons. While it is well known that an individual cannot be compelled to give incriminating testimony against himself, the production of documents can also, in certain instances, be testimonial in nature and may be protected under the Fifth Amendment. This is referred to as the "act of production privilege."

In the past, taxpayers who received summonses seeking records related to undisclosed foreign bank accounts sought to challenge enforcement of the summonses on the grounds that producing such records would be equivalent to giving incriminating testimony. The IRS has up to now successfully asserted the "required records" exception to the act of production privilege, which provides that the act of production privilege does not apply with respect to documents that an individual is specifically required to maintain by law or regulation, because such a requirement imbues a public element into such documents, making them unprivileged. Because holders of foreign bank accounts are required to maintain such records as part of the FBAR requirements, the courts have sided with the IRS and ruled that no Fifth Amendment act of production privilege applies.

Awaiting Resolution

In the context of a summons issued to a taxpayer regarding virtual currency, the result may be different. As has now been made clear by the IRS, virtual currency is treated as property for tax purposes, with no special recordkeeping requirement.

Regardless, those with unreported virtual currency income should strongly consider seeking advice on coming forward to the IRS, becoming compliant, and correcting past noncompliance. Depending on their circumstances, such taxpayers may be able to use the IRS's general voluntary disclosure policy to mitigate the worst consequences of past noncompliance and avoid possible criminal prosecution. ❑

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