# New IRS Cryptocurrency Enforcement Efforts and Opportunities to Become Compliant

*By Michael Sardar*

Cryptocurrency is here to stay. As of November 17, 2019, the top five cryptocurrencies by market capitalization had a combined value of approximately $196 billion, and consumers can now use cryptocurrency in place of legal tender at numerous online and brick-and-mortar retailers. In 2014, the IRS issued Notice 2014-21, which generally provided that cryptocurrency would be treated as property for purposes of income tax and was, therefore, subject to the tax principles generally applicable to transactions involving the creation, sale, and acquisition of property.

## The Compliance Gap

Despite the 2014 guidance, the IRS has found that many taxpayers engaging in taxable cryptocurrency transactions have not in fact reported those transactions. A Treasury Inspector General for Tax Administration (TIGTA) report concluded that cryptocurrency had a greater probability of being used to engage in illegal conduct, including tax evasion, and recommended action. For example, in each year from 2013 to 2015, fewer than 900 individual taxpayers reported a capital gain transaction related to Bitcoin, a seemingly low figure considering its popularity and value at that time.

The IRS has since moved to combat the underreporting of cryptocurrency-related income by taking action on two fronts. First, the IRS has pursued enforcement actions directed at uncovering noncompliant taxpayers. Second, it has issued additional guidance to help clarify the proper reporting of cryptocurrency and to further highlight and publicize that cryptocurrency transactions are reportable where they generate income.

## Enforcement

As noted in a previous installment of this column (Michael Sardar "Digital Currency: Market Value of Bitcoin, Ethereum, and Litecoin," September 2017, http://bit.ly/2M52Frg), in 2016 the IRS issued a John Doe summons to Coinbase, a large cryptocurrency exchange, seeking information about its customers. While Coinbase initially challenged the summons and refused to hand over its customers' information, the IRS ultimately prevailed, and Coinbase was required to provide customer data for all customers with at least $20,000 of cryptocurrency in their accounts. In March 2018, Coinbase provided account data on approximately 13,000 account holders to the IRS.

More recently, and likely based on the information provided to the IRS in response to the Coinbase summons, the IRS has sent targeted letters prompting taxpayers believed to be noncompliant with respect to cryptocurrency reporting to take action to come into compliance. As part of this initiative, the IRS sent out three different letters, with subtle but important differences between them.

***Letter 6174.*** Apparently the softest, this letter refers to a taxpayer "who may not know the requirements for reporting transactions involving cryptocurrency." The letter further notes that taxpayers who receive this letter "do not need to respond to this letter."

***Letter 6174-A.*** This letter is very similar to Letter 6174, but uses more stern language, referring to a taxpayer "who may not have properly reported [their] transactions involving cryptocurrency." This letter notes that taxpayers do not need to respond to the letter, but warns, "however, we may send other correspondence about potential enforcement activity in the future."

***Letter 6173***. This letter refers to taxpayers "who may not have met [their] U.S. tax filing and reporting requirements for transactions involving cryptocurrency." This letter appears to be targeted to taxpayers about whom the IRS has the most serious concerns and mandates a response by the date provided in the letter. Letter 6173 requires that a taxpayer either file original or amended returns to report cryptocurrency transactions or provide a statement, signed under penalty of perjury, explaining why the taxpayer is already in compliance with respect to cryptocurrency reporting. The letter notes that taxpayers who do not respond may be referred for examination.

All of the letters direct taxpayers to additional resources and information on the tax reporting requirements for cryptocurrency, including Notice 2014-21. In addition to prompting voluntary compliance from taxpayers who receive the letters, they serve to put such taxpayers on notice of their cryptocurrency tax obligations. Taxpayers who receive and ignore these letters will not be able to assert ignorance of their obligations in response to future enforcement efforts by the IRS, which can include civil audits, imposition of penalties, and even criminal prosecution.

## Additional Guidance

The IRS has also recently issued additional guidance on the subject of cryptocurrency. The guidance answers numerous questions that were left open after the issuance of Notice 2014-21 and also addresses some new cryptocurrency developments that have raised new tax questions. The purpose of this additional guidance is obviously to answer the specific questions addressed; however, it also serves the larger goal of increasing voluntary compliance. More guidance inevitably translates into increased compliance because it allows taxpayers who wish to be compliant, but do not know the rules, to report and pay tax on their transactions in a correct manner.

In furtherance of that goal, on October 9, 2019, the IRS issued Revenue Ruling 2019-24, supplementing previous guidance. This revenue ruling addresses the tax consequences of "hard forks" and "airdrops." A hard fork occurs when a cryptocurrency, which is generally recorded on a distributed ledger, experiences a diversion, whereby the original (or "legacy") cryptocurrency and all transactions in it continue to be recorded on the original ledger, while the new cryptocurrency is created and recorded on a new ledger. At the time of a hard fork, owners of the legacy currency may or may not receive units of the new currency; this is an airdrop.

Revenue Ruling 2019-24 states that taxpayers who experience a hard fork without an airdrop (i.e., they do not receive any units of the new currency), have not experienced a taxable event at the time of the hard fork. On the other hand, if a taxpayer receives an airdrop of a new currency after a hard fork, the taxpayer has experienced a taxable event and is required to report as income the value of the newly received currency.

Revenue Ruling 2019-24 provides the following examples:

A owns 50 units of cryptocurrency M. Cryptocurrency M experiences a hard fork, resulting in the creation of cryptocurrency N. A, however, does not receive any units of currency N and continues to own only 50 units of currency M. A does not have taxable income as a result of the hard fork.

B owns 50 units of cryptocurrency R. Cryptocurrency R experiences a hard fork, resulting in the creation of cryptocurrency S. On that date, 25 units of currency S are airdropped to B, who has access to the new currency. After the hard fork and airdrop, B now has 50 units of currency R and 25 units of currency S. Because B has received a new asset in the form of currency S, B must recognize taxable income equal to the fair market value of currency S.

Also on October 9, 2019, the IRS issued 43 Frequently Asked Questions (FAQ) addressing additional areas of uncertainty with respect to cryptocurrency. Examples of the FAQ guidance include the following:

- Independent contractors who earn income in the form of cryptocurrency are subject to self-employment tax on that income.
- Wages paid in the form of cryptocurrency are subject to the same withholding rules as wages paid in cash.
- Taxpayers who exchange cryptocurrency for other assets or property, or for a different cryptocurrency, must recognize gain or loss upon such exchange.
- A taxpayer does not recognize gain or loss when transferring cryptocurrency from one wallet or account owned by the taxpayer to another wallet or account also owned by the taxpayer. This is so even if the exchange that facilitates the transfer issues an information return to the taxpayer.
- Taxpayers who own multiple units of the same currency with different cost basis can choose which ones are deemed sold if the taxpayer can specifically identify the units involved in the transaction.
- If a taxpayer cannot identify which specific units are being sold, they are deemed to be sold on a first-in, first-out basis.

## A Strong Compliance Push

The IRS's enforcement efforts and its issuance of substantial guidance with respect to cryptocurrency are clear indications that it takes the issue seriously and will more aggressively pursue taxpayers who continue to be noncompliant regarding cryptocurrency income. As the taxability of cryptocurrency receives increasing publicity, and as the IRS continues to answer cryptocurrency questions, taxpayers who continue to get it wrong will be hard-pressed to argue that such errors were innocent mistakes and will be subject to an increased likelihood of facing civil penalties and criminal consequences. Taxpayers who are not properly reporting cryptocurrency income should quickly seek professional guidance on their tax obligations and their options for coming into compliance. ❑

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***Michael Sardar, JD,*** *is a tax controversy attorney at Kostelanetz & Fink LLP, New York, N.Y.*