

Client Alert

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IRS Begins Notifying Owners of Cryptocurrency of Potential Failures to Report Income and Pay Taxes

On July 26, 2019, the IRS announced that it had begun sending letters to taxpayers who may have failed to properly report income and pay any tax associated with cryptocurrency (which the IRS calls “virtual currency”) transactions or who did not properly report such transactions. The IRS expects to send more than 10,000 letters before the end of August.

There are three variations of what the IRS is calling “educational letters” — “Letter 6173,” “Letter 6174,” and “Letter 6174-A” — which are designed to assist taxpayers with understanding their tax and reporting obligations and how to address any errors. The letters vary in severity, ranging from a suggestion to confirm whether a reporting error or deficiency exists to an allegation of a reporting omission requiring a response. Which variation of the letter a taxpayer receives will depend on the information the IRS has about the recipient.

Taxpayers who have not properly reported their cryptocurrency transactions are, where appropriate, liable for tax, penalties, and interest, and in certain cases, may be subject to criminal prosecution.

Background

In Notice 2014-21, the only formal IRS guidance issued on this topic thus far, the IRS confirmed that cryptocurrencies would be treated as property for income tax purposes and, consequently, would generate a capital gain or loss upon disposition.

A reportable disposition occurs as a result of many typical transactions, such as exchanging a cryptocurrency for fiat currency (e.g., exchanging Bitcoin for US dollars or Euros) or exchanging one cryptocurrency for another (e.g., exchanging Bitcoin for Ether). A reportable disposition also occurs when using a cryptocurrency to pay for goods or services.

The resulting gain or loss from a disposition must be reported on IRS Form 8949, *Sales and Other Dispositions of Capital Assets*, and may have income tax implications for the taxpayer. Additionally, taxpayers who receive cryptocurrency when selling goods or as compensation for employment or other services must include the fair market value of the cryptocurrency as of the date of receipt in his or her gross income. This concept includes “miners” who receive cryptocurrency as a reward for validating transactions and independent contractors who are paid





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in cryptocurrency. There remains some uncertainty regarding the tax treatment of cryptocurrency received via a hard fork¹ or airdrop.²

Further, although the Financial Crimes Enforcement Network (“FinCEN”), a bureau of the US Department of the Treasury, indicates that it does not expect US persons who hold cryptocurrency on a foreign third-party exchange to disclose ownership on FinCEN Form 114, Report of Foreign Bank and Financial Accounts, commonly referred to as an FBAR, it is not clear whether those individuals would nonetheless need to report ownership to on IRS Form 8938, Statement of Specified Foreign Financial Assets.

In the summer of 2018, the Large Business and International Division (“LB&I”) identified “Virtual Currency” as one of the IRS’s dedicated compliance campaigns. As a designated focus of the IRS, the aim was to address noncompliance related to the use of cryptocurrency through various treatment streams including taxpayer outreach and examinations. The IRS also confirmed as part of its July 26, 2019 announcement that it anticipates issuing additional guidance in the near future. We expect the forthcoming guidance will address forks and airdrops, foreign asset ownership reporting, and a number of other issues.

The US Government is Gathering Information on Cryptocurrency Transactions

1. “John Doe” Summons Served on Coinbase

In 2016, the IRS served a “John Doe” summons on Coinbase, one of the most prominent cryptocurrency exchanges, and in February of 2018, pursuant to an order from a federal district court, Coinbase provided the IRS with the taxpayer identification numbers, names, dates of birth, addresses, and transaction information covering 2013 through 2015 for approximately 13,000 of its customers.

The information received from Coinbase may likely form the basis of forthcoming criminal tax cases. Don Fort, the chief of the IRS’s Criminal Investigation Division, recently announced that the IRS is building criminal tax-evasion cases involving cryptocurrency and expects to make them public soon. And, while the IRS declined to comment on whether any of the “educational letters” stem from Coinbase’s response to the summons, it is safe to assume that at least some of them do.

¹ A hard fork is a change to the software of the cryptocurrency that creates two separate versions of the blockchain with a shared history. The original owner of the cryptocurrency subject to a hard fork retains its interest in the original cryptocurrency and also has the right to use the forked cryptocurrency.

² An airdrop is a distribution of cryptocurrency tokens or coins to a significant number of wallet addresses, usually for free or incidental to an action of the owners of the recipient wallet addresses.



2. SEC Plans to Hire Contractors to Run Cryptocurrency Full Nodes

The US Securities and Exchange Commission (“SEC”) published a document indicating plans to run through contractors a Bitcoin and an Ethereum full node and nodes on as many as possible of the following blockchains: Bitcoin Cash, Stellar, Zcash, EOS, NEO, and XRP Ledger. The SEC is seeking the full ledgers since inception (i.e., the genesis block) and all derivative currencies (tokens) for all of those blockchains. Further information is limited at this time, but the SEC stated that the purpose would be “to support its efforts to monitor risk, improve compliance, and inform Commission policy with respect to digital assets.”

This development follows notable activity by the SEC in the cryptocurrency space, including an April 2, 2019 No Action Letter regarding TurnKey Jet, Inc., an April 3, 2019 Statement on “Framework for ‘Investment Contract’ Analysis of Digital Assets”, and a July 25, 2019 No Action Letter regarding Pocket Full of Quarters, Inc.

As the US government continues to focus on compliance issues related to cryptocurrencies, it is reasonable to expect that other agencies, including the IRS, will follow the SEC and begin accessing and monitoring entire cryptocurrency blockchain ledgers through a full node. A move like this would make it much easier for the IRS to match cryptocurrency activity with the information reported on an income tax return.

3. FinCEN Requires Certain Cryptocurrency Businesses to Record Customer Data and File Reports

On May 9, 2019, FinCEN issued guidance intended to help businesses that deal with cryptocurrencies and address obligations as money service businesses under the Bank Secrecy Act. FinCEN collects and analyzes data about financial transactions to combat domestic and international money laundering, terrorist financing, and other financial crimes. FinCEN’s guidance makes clear that cryptocurrency businesses that constitute a “money services business” must create and maintain an Anti-Money Laundering program and recordkeeping about its customers and, when appropriate, file suspicious activity reports and currency transaction reports.

What Should Owners of Cryptocurrency Do?

Taxpayers who own or have disposed of cryptocurrency, especially those who receive one of the educational letters from the IRS, need to consider whether they have any reporting or tax obligations stemming from their cryptocurrency. IRS Commissioner Chuck Rettig, warns that “[t]axpayers should take these letters very seriously by reviewing their tax filing and when appropriate, amend[ing] past returns and pay[ing] back taxes, interest, and penalties. The IRS is expanding [its] efforts involving virtual currency, including increased use of data analytics ... [and

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is] focused on enforcing that law and helping taxpayers fully understand and meet their obligations.” If a taxpayer receives one of the “educational letters,” they should immediately contact their US tax advisor who will be able to assist them in determining how best to move forward.

Taxpayers who own or have disposed of cryptocurrency but do not receive one of the IRS letters are still advised to carefully evaluate their transactions and holdings to determine whether or not they have been fully compliant with their tax and reporting obligations. In light of the recent activity of the US tax, securities and financial crimes regulators, it is becoming increasingly clear that the US government is intent on monitoring and regulating cryptocurrency transactions. It is not prudent to consider cryptocurrency transactions to be anonymous, and a delay in addressing any noncompliance with tax and reporting obligations vis-à-vis the IRS may limit one’s options or exacerbate the issue.

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