

How Tax Authorities Are Responding To Cryptocurrency

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The features that make cryptocurrencies attractive to their users — relative anonymity and mobility — have created heightened concerns with regulatory agencies in the United States and abroad. Recent enforcement actions highlight a growing focus by regulatory agencies on cryptocurrency businesses and an increased number of enforcement actions and prosecutions. In addition, there are reasons to expect that the scope and character of the violations alleged as part of these government actions may increase. While the vast majority of cryptocurrency-related enforcement actions have been related to anti-money-laundering and securities violations, both American and non-U.S. authorities have signaled that they are deeply concerned about the tax implications of greater adoption of cryptocurrencies without greater accountability procedures and transparency.

The IRS' first foray into cryptocurrency came on March 25, 2014, when the IRS issued guidance explaining that it will treat cryptocurrency as property. In February 2018, the IRS Criminal Investigation Division announced that it formed a new team to focus on international crimes, in particular undeclared cryptocurrency income and assets. When asked about the creation of the new team, the chief of the IRS Criminal Investigation Division stated, "It's possible to use bitcoin and other cryptocurrencies in the same fashion as foreign bank accounts to facilitate tax evasion."^[1] This statement follows a federal court order, requiring Coinbase — one of the largest virtual-wallet providers in the world — to provide data on thousands of customers to the IRS. In November 2016, the IRS served a "John Doe" summons on Coinbase for all U.S. customers who transferred bitcoin between 2013 and 2015. The IRS stated the subpoena was needed to understand the full scope of previously identified tax noncompliance and underreporting among Coinbase's customers. Late last year, after a court battle, a California federal court narrowed the scope of the subpoena to all users who have bought, sold, sent or received more than \$20,000 through their accounts in a single year and ordered Coinbase to provide the IRS with identifying data on the covered accounts.^[2] In the end, Coinbase produced data on 8.9 million transactions and approximately 14,000 customers.^[3]

The United States is not the only country to be concerned about how the anonymity and mobility of cryptocurrencies will affect the tax rolls. In January 2018, tax authorities in South Korea — the world's third-largest cryptocurrency market — raided the country's largest cryptocurrency exchanges due to alleged tax evasion.^[4] Announcements by



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central banking authorities in Europe suggest that they too are concerned with the potential for tax evasion. For example, in February, the finance ministers and central bank leaders of France and Germany wrote a joint letter to the G-20 calling for greater regulation of cryptocurrencies.[5] The two countries expressed worry that cryptocurrencies “can be vulnerable to financial crime without proper appropriate measures” and called for “transboundary” action to regulate the currencies.[6]

Given the recent enforcement actions by the U.S. Securities and Exchange Commission, the Financial Crimes Enforcement Network, the U.S. Commodity Futures Trading Commission, and the U.S. Department of Justice, actors who are offering — or plan to offer — accounts, trading and other services to holders of cryptocurrencies should take necessary precautions to ensure that they are complying with applicable U.S. federal income and foreign tax regulations. To better understand the precautions, we will first discuss the background of cryptocurrencies. The remainder of this article will:

- Outline U.S. federal income tax regulations on cryptocurrencies;
- Discuss a series of best practices based on the Swiss Bank Program, which addressed similar accountability and transparency concerns; and
- Briefly discuss cryptocurrency trends abroad.

Background on Cryptocurrency

Bitcoin and other cryptocurrencies are decentralized digital currencies. Unlike government-issued fiat currency, cryptocurrency systems lack a central bank and all transactions take place between users — peer to peer. Transactions are recorded on a blockchain, a shared distributed ledger.[7] A blockchain is what ensures that each digital coin is spent only once, allowing cryptocurrency to exist without a central authority.

Bitcoin — the first and most valuable cryptocurrency — became available in 2009. There are now over 20 cryptocurrencies with a market capitalization of over \$1 billion.[8] Bitcoin is the largest, followed by ethereum and ripple.[9]

Users conduct cryptocurrency transactions through a virtual wallet. The wallets store the cryptocurrency and facilitate transactions between parties. Wallets can be hardware-based or software-based, software wallets can be hosted on the cloud, personal computers or mobile devices.[10] There are also cryptocurrency exchanges (such as Coinbase) that permit a person to buy and sell cryptocurrency like a government-issued fiat currency.

While bitcoin and its successors were little accepted when they first became available, they have rapidly grown in acceptability. Today, a wide range of businesses accept bitcoin and the other popular cryptocurrencies as payment, including a large software company, public universities and some accounting firms.[11] However, the acceptance of cryptocurrencies is not universal— for example, at least one large U.S.-based bank does not allow its customers to pay for cryptocurrency with funds in its accounts.[12] Also, the recent sharp spike and subsequent fall in the value of bitcoin and other cryptocurrencies prompted some vendors to pull out of the market. A U.K.-based multinational bank and a U.S.-based financial-services corporation blocked their credit card customers from using their cards at cryptocurrency exchanges.[13]

Still, interest in cryptocurrencies remains high. Businesses wishing to provide services to users of cryptocurrencies should take proper precautions to ensure that they are not running afoul of relevant

U.S. federal income tax regulations.

U.S. Federal Income Tax Compliance and Cryptocurrency

Guidance from the IRS that was published in 2014 clearly states that receiving or transacting in cryptocurrencies is potentially taxable.[14] Essentially, under current U.S. law, cryptocurrency is treated like property, not currency, and the general tax rules applicable to property transactions also apply to cryptocurrency transactions. If taxpayers receive cryptocurrency in exchange for the performance of services, they must include the fair market value of that currency as compensation when computing their gross incomes.[15] If taxpayers use cryptocurrency to purchase goods or services, they are treated as engaging in two separate transactions: (1) the sale of property (cryptocurrency) and (2) using the proceeds of the sale to purchase new goods or property. If taxpayers buy a cryptocurrency at a low price and then sell it at a high price, the difference is generally taxable as capital gain.[16]

In early 2018, the IRS announced the creation of a new investigation team that will focus on international crimes, including ones involving cryptocurrency. In particular, the division will focus on tax evasion and unlicensed cryptocurrency exchanges.[17] The creation of this new team signals that the IRS' interest in cryptocurrencies goes well beyond the proper valuation of such currencies. The IRS fears that widespread tax noncompliance may exist among cryptocurrency users — and these fears are echoed in other countries with large cryptocurrency markets.[18] Indeed, the U.S. secretary of the Treasury recently stated that — without proper regulation — bitcoin could become the next “Swiss numbered bank accounts.”[19] Thus, lessons from the IRS' Swiss Bank Program that was used to mitigate problems in those accounts may provide guidance to actors in this space.

Swiss Bank Program

Swiss privacy laws, like cryptocurrency, provide a great deal of anonymity to persons' or entities' relative banking transactions, often allowing account holders to evade U.S. federal income obligations — sometimes with the knowledge or assistance of Swiss banks. The DOJ Tax Division announced the Swiss Bank Program in August 2013. Before the announcement of the program, the IRS and the Tax Division had serious concerns that individuals were evading U.S. federal income taxes and reporting requirements through the use of Swiss bank accounts. The purpose of the program was to create a path for Swiss banks to provide information on the suspect accounts and to reform their practices. In exchange for the banks' cooperation and often a substantial monetary fine, the Tax Division agreed to not prosecute the banks for tax- or monetary-related offenses.[20] Seventy-eight nonprosecution agreements were made under the program in 2015 and 2016.[21]

Lessons From the Swiss Bank Program

Looking at the NPAs created as a result of the Swiss Bank Program provides a list of best practices for financial services providers in the cryptocurrency space. Providers should appropriately identify and evaluate persons looking to open accounts/wallets or to engage in other cryptocurrency transactions, assess potential risks associated with the customer or transaction, and make appropriate changes to policies following announcements or enforcement actions by the IRS or other regulators.

Notably, the recently announced IRS team is focused on international crimes; thus, these practices can apply to any actor who wishes to offer cryptocurrency services to U.S. citizens or others who are obligated to pay taxes in the U.S. — not just those based in the U.S.[22]

First, offerors or providers of cryptocurrency services should create policies that will mitigate the risk of facilitating tax evasion. They should ban transactions that could conceal the identity of a client, such as cryptocurrency tumblers or transaction mixing, which combine several accounts/transactions together to obscure the original source and/or eventual destination of the funds. Similarly, cryptocurrency exchanges and wallet providers (“financial services providers”) should hold accounts/wallets only under the U.S. person’s real name — not under nominal structures/trusts or under numbers only. The know-your-customer, or KYC, program should identify the beneficial owners of any cryptocurrency on deposit or being transferred. Employees should be trained to obtain complete identification on an account holder, including the holder’s name and country of citizenship.

When opening accounts/wallets, the financial services provider should also conduct a proper risk assessment to ensure that the financial services provider does not open a cryptocurrency account for someone looking to evade U.S. federal income obligations or seeking to engage in other criminal activity. An initial evaluation should consider whether the person appears to be trying to avoid declaring income to the IRS. For example, the KYC program should ask if the person is moving from a provider that recently instituted changes to its privacy and reporting requirements.[23] The institution should identify the origin of the money used to fund the account or cryptocurrency transaction. Finally, the financial institution should set appropriate limits to trigger additional reviews. In setting these limits, the institution may borrow limits from its existing anti-money laundering/Bank Secrecy Act programs. The institution may also coordinate limits and policies addressing cryptocurrencies with anti-corruption, prudential-regulation compliance, and even business risk management programs. Finally, enforcement actions can provide guidance. For example, the IRS’ action against Coinbase may provide a useful benchmark; accounts over \$20,000 were subject to the reporting order.

Relatedly, cryptocurrency services providers, should keep abreast of enforcement actions and statements by regulators in this space. Several of the Swiss banks were penalized for failing to modify their account practices after the IRS announced its enforcement actions against UBS AG (the first Swiss Bank enforcement action).[24] On the other hand, banks that took steps to improve their practices following the UBS deferred prosecution agreement received a substantial credit for those improvements.[25] Thus, for virtual-wallet providers, the recent decision from the district court ordering Coinbase to provide certain customer data to the IRS may spur an evaluation of policies and practices regarding the collection and reporting of identifying account information.

Finally, all employees who handle cryptocurrency accounts should receive appropriate training. This training should include recognizing potential tax evasion, U.S. federal income requirements for cryptocurrencies, and appropriate methods of gathering customer identification information. Existing AML/BSA training should be updated to emphasize that these rules also apply to cryptocurrency.[26]

Beyond the United States

The United States is not the only country grappling with how best to respond to the growing use of cryptocurrencies. Other countries with large amounts of cryptocurrency transactions have signaled that they too are concerned about potential tax evasion.

For example, South Korea recently increased enforcement targeting cryptocurrency exchanges. Tax authorities raided the country’s largest exchanges over concerns of potential tax evasion. Following the raids in January 2018, South Korea also issued new regulations creating greater government oversight, banning anonymous transactions, and announcing continual monitoring of cryptocurrency exchanges.[27] Specifically, parties are only allowed to trade in cryptocurrencies using accounts under

their real names. Authorities also reminded financial services providers that KYC and AML rules apply to cryptocurrency transactions.[28]

The G-20 also addressed the issue of cryptocurrency regulations at its summit in March of this year.[29] The G-20 tasked the Financial Action Task Force, the Organization for Economic Cooperation and Development, and the central bank presidents with developing a series of regulatory recommendations by July 2018. The exact contours of these recommendations are not yet known, but they are expected to focus on the proper taxation of cryptocurrencies and crime prevention, including terrorism financing, money laundering and fraudulent initial coin offerings.[30] Furthermore, like the current stance of the IRS, the G-20 sees cryptocurrencies as property, referring to them as “crypto-assets” rather than a currency.[31]

Similarly, the European Union is discussing cryptocurrency regulations. These discussions are only high-level framework talks at this time, but they do include consideration of the need for stricter regulations. France ordered its central bank to design regulations against tax evasion and terrorist funding with cryptocurrencies. Additionally, Germany and France continue to push for the adoption of international regulations of cryptocurrencies.[32] Regulators in the United Kingdom have taken similar positions.[33]

Conclusion

Regulators and taxing authorities are worried about the greater adoption of cryptocurrencies. They are working to develop new regulations and guidance for financial services providers and account holders. In the absence of cryptocurrency-specific regulations, the U.S. Swiss Bank Program provides useful guidance for financial services providers that wish to offer services to cryptocurrency holders. Providers of financial services to cryptocurrency holders should take steps to ensure that they are not enabling tax evasion. These steps may include ensuring that their clients are fully and accurately identified, developing a policy to identify risky accounts, and fully educating all employees who handle U.S. accounts on the applicable U.S. tax laws and regulations. Given the changing landscape regarding these issues, actors should keep abreast of announcements by U.S. (and applicable foreign) regulators and modify their compliance practices as necessary.

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[16] Id.

[17] <https://www.bloomberg.com/news/articles/2018-02-08/irs-cops-scouring-crypto-accounts-to-build-tax-evasion-cases>

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[19] Richard Holden and Anup Malani, Why the IRS Fears Bitcoin, Jan 22, 2108, NY Times, <https://www.nytimes.com/2018/01/22/opinion/irs-bitcoin-fear.html>; <https://www.cnbc.com/2018/01/12/mnuchin-wants-to-make-sure-bad-guys-cant-use-cryptocurrencies.html> (interview with S. Mnuchin) regarding cryptocurrency.

[20] Joint Statement between the us Department of Justice and the Swiss Federal Department of Finance, available at <https://www.justice.gov/tax/file/631356/download>

[21] <https://www.justice.gov/tax/swiss-bank-program>

[22] <https://www.bloomberg.com/news/articles/2018-02-08/irs-cops-scouring-crypto-accounts-to>

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[23] Nonprosecution Agreement entered into by Bank Sparhafen-Zurich AG and the us DOJ, Tax Division, available at <https://www.justice.gov/opa/file/479601/download>. The NPA noted that Bank Sparhafen opened several accounts for U.S. persons after those individuals were required to close their accounts at Swiss banks that recently announced stricter reporting requirements for U.S. customers.

[24] Id.

[25] Nonprosecution agreement entered into by Bank LaRoche Co. G and the us DOJ, Tax Division, available <https://www.justice.gov/opa/pr/bank-la-roche-co-ag-reaches-resolution-under-justice-departments-swiss-bank-program>

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