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PERSPECTIVE

IRS and cryptocurrencies: Coinbase is just the beginning

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Last year was a breakout year for cryptocurrencies. At its height, bitcoin's value increased by more than 20 times from the start of the 2017, and ether and litecoin saw gains of more than 80 times. As prices soared, the number of cryptocurrencies also proliferated as thousands of companies, big and small, lasting and ephemeral, sought to issue their own cryptocurrencies in lieu of traditional financing.

Now that cryptocurrencies (and the blockchain technology underlying them) have expanded beyond dorm rooms, garages and basements, commandeering attention from mainstream investors and Wall Street traders alike, regulators and other governmental authorities are taking note. Given the combination of significant gains in crypto asset values and the heightened potential for their underreporting due to the nature of blockchain technology, it is no surprise that the Internal Revenue Service is among the entities most actively asserting itself.

One of the latest IRS efforts ostensibly targets frequent users of Coinbase, one of the largest retail brokerage platforms for four of the most popular mainstream cryptocurrencies (bitcoin, bitcoin cash, ether, and litecoin). In November 2017, a California federal court ordered Coinbase to provide the IRS with certain records related to all Coinbase users who bought, sold, sent or received more than $20,000 worth of cryptocurrencies (in any of these four types of transactions) in a single year between 2013 and 2015. Coinbase estimates that more than 14,000 of its users are subject to such reporting.

Many may remember the IRS's similar John Doe summons efforts against UBS in 2008 and HSBC India in 2011. These precipitated the crackdown on unreported foreign accounts and income that continues today. The Coinbase ruling was ultimately much narrower than the initial IRS request, which essentially required Coinbase to turn over users' identifying information and detailed records of transactions and activities conducted through their accounts. Still, the IRS's initial salvo in the case portends potentially significant further investigative and enforcement efforts. All cryptocurrency exchanges and digital wallet providers should be on high alert, as should taxpayers who have recognized income from cryptocurrency transactions, whether from trading activity or from accepting or making payments for goods or services. Companies providing payroll and 1099 reporting services should probably expect cryptocurrencies to be subject to third-party information reporting in the future.

BLOCKCHAIN AND THE LAW

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The initial summons the IRS sought to enforce included a laundry list of information and documents beyond what the ruling ultimately granted (although the court noted that some such information could become relevant as the IRS investigation continues). In addition to users' identifying information and activity records, the IRS originally sought complete user profiles, Coinbase's know-your-customer due diligence, information about third-parties authorized to access users' accounts, correspondence between Coinbase and users, and AML exception records. Further, the initial summons did not include the $20,000 threshold, which was only introduced in a subsequent narrowed summons after eight months of back-and-forth in the case.

The information sought by the IRS in the initial summons suggests its interests exceed the frequent traders that it purports the ruling targets, and its concerns perhaps extend beyond the accurate reporting of capital gains or other income. It is unlikely the IRS's interest will wane or that its focus will narrow as cryptocurrency adoption and transaction volume continue to grow. It also is worthwhile to note the IRS made no specific claim of suspicion or allegation of wrongdoing as to any particular user, but argued (and the court agreed) that its summons was justified given the size discrepancy between Coinbase's user base (roughly 6 million) and the number of U.S. taxpayers who reported cryptocurrency holdings (fewer than 1,000). The IRS points to this discrepancy as evidence of the heightened underreporting risk.

The timing of the IRS's initial summons, filed in November 2016, is also notable. The statute of limitations for the IRS to assess taxes for 2013 (the earliest year covered by the summons) would have run in April 2017 (three years from the due date for 2013 tax returns), except in cases where there is a substantial omission (six-year SOL) or fraud, false return, missing return or willful attempt to evade taxes (no SOL). It appears the timing of the summons was meant to give the IRS enough time to investigate and audit any taxpayer who might have underreported cryptocurrency gains, not only those egregious cases that might have fallen into the six-year SOL or no-SOL categories. Again, this suggests the IRS's gaze is not confined to the most active crypto traders.

Finally, the IRS's decision to take a transactional-volume approach in its summons raises an interesting issue about the future of IRS enforcement in the cryptocurrency space. The IRS simply could have tried asking Coinbase to report users' capital gains and losses, but such a request would not have yielded useful results. Coinbase users are free to transfer their crypto assets onto and off the platform (to/from both themselves and third parties), and, due to the nature of blockchain technology, such crypto trails could be difficult or even impossible to tie back to an identifiable individual. Practically, this means Coinbase lacks reliable information about its users' basis in crypto assets needed to calculate gain or loss (or, indeed, even to know whether a transaction implicates capital gains or represents some other type of receipt that requires a different type of tax treatment), except maybe in cases where all of a user's activities are confined to the Coinbase platform.

Instead, the IRS resorted to a transactional-volume approach, requiring Coinbase to provide the identities and transactional records of all users who engaged in $20,000 of crypto related activity. The problem with this approach, however, is it is not scalable or sustainable as crypto-trading explodes in volume and mainstream adoption because it still requires the IRS to do significant investigative work after receiving information from Coinbase (or any other cryptocurrency exchange). Instead, the IRS may soon discover a need for a more administrable approach to taxing crypto gains — for example, a withholding tax regime where exchanges like Coinbase are required to withhold taxes on each transaction (after all, the IRS has adopted a similar approach in other situations where tax compliance may be difficult to ensure, such as certain payments to foreign persons). Undoubtedly the crypto community would find such a solution antithetical to its philosophy, but the stakes are rising for the IRS (and other authorities) with every rally and surge in crypto asset values, and with increasing transaction volumes as more businesses accept payment in cryptocurrencies.

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