

## US IRS begins to increase enforcement efforts in cryptocurrency space

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### Executive summary

In recent weeks, the United States (US) Internal Revenue Service (IRS) has sent letters (Letter 6173, Letter 6174, or Letter 6174-A) to approximately 10,000 taxpayers with regard to cryptocurrency transactions. This signals a serious step-up in enforcement efforts by the IRS in the cryptocurrency space since the 2 July 2018, announcement of the virtual currency campaign that indicated that the IRS was not contemplating a voluntary disclosure program specifically to address tax non-compliance involving virtual currency. The following is a brief overview of the taxation of cryptocurrency transactions, the content of Letters 6173, 6174, and 6174-A, and action items. In all three letters, the IRS has provided "educational" material and a hotline number for questions related to the letters, promising a response within three business days.

Additionally, some taxpayers are reporting receipt of CP2000 notices from the IRS, which assert that the taxpayer has underpaid tax with respect to cryptocurrency transactions. Unlike Letters 6173, 6174, and 6174-A, the CP2000 notice contains the IRS's calculation of underpaid tax, plus interest.

## Detailed discussion

### Brief overview of taxation of cryptocurrency transactions

The IRS has issued limited guidance on the taxation of cryptocurrencies, namely Notice 2014-21, 2014-16 IRB 938 (the Notice). Generally, the Notice treats “convertible virtual currency” as property, rather than currency, for federal tax purposes.<sup>1</sup>

Gain or loss on cryptocurrency transactions is calculated in the same manner as other property sales:  $\text{gain/loss} = \text{amount realized} - \text{adjusted basis}$ . Both the amount realized and adjusted basis must be converted to US dollars for federal tax reporting purposes. The character of the gain/loss depends on whether the cryptocurrency is a capital asset in the taxpayer's hands.

### CP2000 notice

The CP2000 notice is likely the most severe. The IRS sends this notice when the income or payment information that it has on file does not match the information that the taxpayer reported on his/her tax return. Potentially, the discrepancy between the IRS's and taxpayer's calculations of cryptocurrency transaction income (and tax due thereon) could come from the fact that cryptocurrency exchanges have been issuing Forms 1099-K to traders. This could mean that a taxpayer's cryptocurrency transactions may have been reported to the IRS in a way that does not reflect actual gains/losses, because Form 1099-K only reports income, but not basis, gains, or losses.

What actions need to be taken?

- ▶ The taxpayer should review his/her cryptocurrency transactions to determine whether the IRS has accurately calculated underreported income/underpaid tax.
- ▶ The taxpayer must respond to the CP2000 notice within 30 days, by either: (1) paying the amount due as calculated by the IRS; or (2) disputing the IRS's calculation and providing an explanatory statement and supporting documentation.

### Letter 6173

Letter 6173 is only somewhat less severe than the CP2000. The language indicates that the IRS knows that the taxpayer owns cryptocurrency, but did not report any income with respect to that cryptocurrency on his/her income tax return.

That is, the IRS may potentially know that a taxpayer has unreported or underreported income with respect to his/her cryptocurrency transactions.

What actions need to be taken?

- ▶ The taxpayer should review his/her cryptocurrency transactions to determine if he or she failed to report any income.
- ▶ If there was unreported or underreported income associated with the individual's cryptocurrency transactions, then the taxpayer must reply with a late or amended return, and include the underreported income.
- ▶ If there was no underreported income associated with the individual's cryptocurrency transactions, then the taxpayer must reply with an explanatory statement, signed under penalty of perjury.

### Letter 6174

Letter 6174 seems to be less severe than the CP2000 notice and Letter 6173. The language indicates that the IRS knows that the taxpayer owns cryptocurrency, but that the IRS might not necessarily know whether the taxpayer has unreported/underreported income related to cryptocurrency transactions.

What actions need to be taken?

- ▶ Letter 6174 instructs the taxpayer to review some “educational” material, and to then amend or file if reporting was not properly performed.
- ▶ Otherwise, no response is necessary.

### Letter 6174-A

Letter 6174-A seems to be the least severe of the three new cryptocurrency letters. The language indicates that the IRS knows that the taxpayer reported cryptocurrency transactions on his/her income tax return, but potentially reported those transactions incorrectly. For example, the taxpayer may have reported the transaction on the wrong schedule.

What actions need to be taken?

- ▶ Like Letter 6174, Letter 6174-A instructs the taxpayer to review some “educational” material, and to then amend or file if reporting was not properly performed.
- ▶ Otherwise, no response is necessary.

## Implications

By issuing these letters, the IRS is seemingly giving taxpayers a chance to amend returns to correct underreported income related to, or improper reporting of, their cryptocurrency transactions. Taxpayers who do not take advantage of this opportunity risk exposure to increasingly aggressive (and potentially less forgiving) future IRS enforcement, including possible imposition of penalties and interest charges on underreported tax. Although the letters are not actual examinations, failure to respond may result in the IRS initiating an audit.

In addition, taxpayers should be aware that while gains/losses realized in connection with the sale or exchange of cryptocurrencies should generally be recognized for federal income tax purposes, additional tax issues arise in connection

with cryptocurrencies for which little guidance is currently available. For example, little guidance is available on the impact of a “fork” in a particular blockchain that could give rise to two different digital assets (and the need to assess taxability of any new assets resulting from such fork, as well as potential basis adjustments). Additionally, little guidance is available on transactions involving assets received pursuant to an “airdrop” in which the owner of a digital wallet in one cryptocurrency is given rights to a new wallet/cryptocurrency as a method of broadly distributing the new cryptocurrency. There are numerous other issues impacting those trading or investing in cryptocurrencies for which little guidance is available as of the time of this Tax Alert. Accordingly, both taxpayers and their advisors should consult with professionals that have experience in dealing with these matters.

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## Endnote

1. The Notice defines “convertible virtual currency” as “virtual currency that has an equivalent value in real currency or that acts as a substitute for real currency ... Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, US dollars, Euros, and other real or virtual currencies.” It seems clear that cryptocurrencies that can be directly exchanged for fiat currency (e.g., Bitcoin, Ethereum, Ripple, Litecoin, etc.) should qualify as “convertible virtual currencies.” There may be some grey area as to whether the Notice covers virtual currencies that cannot be directly exchanged for fiat currency. For purposes of this article, we assume that all virtual currencies are treated as property for tax purposes.

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