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The IRS Should Cage the Crypto Kraken

By Jason Morton[*]
Webb & Morton
Arlington, VA

Good war planning evolves in stages, from strategic, to tactical, to political. The IRS appears to be in its operational phase, building a cryptocurrency campaign. Two developments signal a strong shift in IRS enforcement. These developments dwarf some 10,000 IRS letters sent to crypto users in 2019 warning them of potential compliance deficiencies. These letters were just the arrow across the bow, while the new developments are wargaming. Crypto-diplomacy and amnesty appear to be lost.

IRS SB/SE ANNUAL REPORT

The IRS's promises in 2019 came true. In a 2019 Annual Report published by the IRS Small Business/Self-Employed Tax (SB/SE) Division,[1] the IRS declared cryptocurrency to be an important focal point for enforcement and compliance. The crypto discussion is wedged neatly near taxpayer fraud and highlights Bank Secrecy Act examinations. In tax circles, fraud and secrecy are not good bedfellows. The IRS cast a shadow on cryptocurrency and it was pitch black.

The Annual Report discusses the establishment of a virtual currency task force. It will assist in resolving crypto tax compliance and make audit recommendations. The increased training of cryptocurrency subject matter experts and technical personnel is also highlighted. The educational expectations do not stop there, however. Now, the IRS expects everyday taxpayers to be crypto-conscious. In 2020, IRS Form 1040 will boast a new ''virtual currency'' disclosure question *ahead of* naming dependents, and IRS Form 433-A, the IRS's primary financial collections tool, asks taxpayers to attach their *public keys* for each cryptocurrency they own. Both seek a peek inside taxpayer's crypto wallet. It also creates as trap for those susceptible to nondisclosures, setting the stage for perjury.

IRS IRM GOVERNING CRYPTOCURRENCY

The crypto-concentration trickles down to the IRS's personnel ''playbook,'' the Internal Revenue Manual (IRM).[2] In it, the IRS attempts to solve the complex with simplicity. It instructs IRS Examiners to value cryptocurrency in the same manner as publicly traded stocks, ignoring that digital exchanges vary on spot prices and tracking cost basis with multiple transactions across multiple exchanges is exhausting at best. Plus, third-party crypto reporting by the exchanges themselves is slim to none. This IRM guidance is sure to overload the IRS Appeals process.

IRS Collections is not lost in the crypto-mix. In the IRM, IRS Collections devotes four subparts to explaining virtual currencies, understanding its various storage types, and identifying cryptocurrency activities and sources. It says, rather inadequately, that virtual currency may be identified through *normal* col-

[*] Jason has practiced law for over 12 years (10 in NC). He most recently returned from a 2.5-year active duty tour with the NC Army National Guard in 2018. He focuses on tax defense (foreign and domestic), estate planning, business law, asset protection, and the taxation of cryptocurrency. Jason has specific interests in special needs planning, offers in compromise, foreign tax defense, and the taxation of cryptocurrencies. He most recently studied blockchain and cryptocurrency at the University of California-Berkeley. Jason attended the University of Dayton School of Law and the George Washington University School of Law, studying government procurement. Jason is also a Judge Advocate (JAG) with the North Carolina Army National Guard. He is assigned to Trial Defense Services, where he defends soldiers before Army Discharge Boards and against other adverse command action. Jason has served in the National Guard over 10 years, with being active for three of them.

[1] IRS 2019 Small Business/Self Employed Annual Report, available at https://www.irs.gov/pub/irs-pdf/p5409.pdf.

[2] IRM 5.1.18.20 (7-17-2019), IRM 5.1.18.20.1 (7-17-2019), IRM 5.1.18.20.2 (7-17-2019), IRM 5.1.18.20.3 (7-17-2019).

lection investigative techniques. That direction assumes too much, especially for those crypto users using privacy coins like Monero.

Monero is said to be untraceable, and transactions on Bitcoin's Lightning Network are conducted unseen and apart from Bitcoin's public ledger. Plus, private keys are virtually undiscoverable, only known to its owner. These are just a few of the unprecedented challenges to *normal* investigative techniques. It is unlikely that even the Coinbase victory uncovered the private keys of taxpayers. The Coinbase Summons did however cover nearly nine million transactions of over 14,000 account holders.[3] It also led to caselaw establishing that crypto users have no reasonable expectation of privacy with transactions on digital exchanges.

Despite this, without a taxpayer's private key, it is unlikely the IRS could ever know every transaction a taxpayer transacted. Presently, no amount of *normal* investigative measures will produce it. Plus, unlike other asset classes, third-party reporting of crypto transactions is sparse at best, something relied on heavily by investigators. There is little ''normal'' in the world of virtual currencies. Surely recognizing this, enter IRS development number two.

The IRS is smart enough not to release its kraken too soon. With virtually unlimited taxpayer dollars, it recently sought to lessen its learning curve. With $625,000 in its pocket, in September 2020, the IRS quietly offered a procurement contract asking private contractors to solve the puzzle of privacy coins (like Monero).[4] The stated goal was to expand the IRS's internal capabilities and reduce reliance on outside vendors. In its Request for Proposal (RFP), the IRS admits it that struggles with identifying ways to advance and deploy innovative technological solutions. Specifically, the RFP seeks solutions to trace privacy coins in ''off-chain'' transactions. The RFP wants contractors to provide the Treasury with ''tools, data, source code, algorithms, and software development services'' to assist IRS Cyber Crimes Agents. In fact, privacy coin Monero is named specifically in the RFP.

CRYPTO TRADING PLATFORM ISSUES AND CONCERNS

The puzzle of privacy coins is a difficult one. Bitcoin discloses its ledger publicly — identifying a particular transaction's date, time, and amount with pseudo-anonymity for the sender and receiver. With some forensic effort, the IRS Criminal Investigation Division (IRS-CI) can locate a private sender of cryptocurrency. The same cannot be said of privacy coins. They operate in their own private space (some would call it, ''secret'' space). This is obviously a problem for the IRS-CI.

In effect, privacy coins transact business in a shared muliti-signature wallet — an anonymous wallet, only known to the sender and receiver. Inside that shared wallet, they can transact unlimited transactions until they decide to close its channel. At closure, the last validated balance sheet is added to join the main public Bitcoin ledger. Up until that time however, the transactions are only seen by the sender and receiver of the privacy coins. By the time the privacy coin (closed) balance sheet hits the blockchain, the transactions and anonymity are complete. The IRS sees the end result but does not see the transactions giving rise to the result.

Privacy coins promote themselves as a way to achieve scalability and greatly improve transaction times — claiming speeds of 1 million transactions per second (Bitcoin sits at seven per second and Visa 47,000). There is certainly validity to those goals. However, the unintended benefit is superior privacy. And the IRS does not take kindly to what it cannot see. It cites several social concerns, like terrorist funding, drug trafficking, and child exploitation. It does not take much however to see other ancillary objectives.

The IRS is justified in its concerns. A tax system built on voluntary disclosure is sure to crumble on the backs of cloaked transactions. But fueling the jets may not be the best course of action right now. The IRS is still in its infancy with its cryptocurrency understanding, tracking, compliance, and enforcement, as is the average taxpayer. Just last year, IRS Commissioner Chuck Rettig called cryptocurrency an ''emerging area'' for taxpayers, acknowledging the complication of understanding tax obligations in a ''rapidly changing environment.''[5] While mounting a strong force is smart, the better course of valor now may be diplomacy (and *amnesty*).

Sending 10,000 threating letters and trying to outsmart those with a 10-year head start may not prove as effective as the IRS may think. It is time to revisit an IRS Crypto Amnesty Program (ICAP). There was talk years ago that the IRS may consider it. Since that time however, the IRS has signaled a strong intent not to extend the olive branch — for reasons unknown. Whatever the reasons, good public policy and the fair administration of the tax laws favors amnesty.

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[3] *See* Mark Aquilio, *Court grants IRS summons of Coinbase records*, Journal of Accountancy (Mar. 1, 2018). *See also United States v. Coinbase, Inc.*, No. 17-cv-01431-JSC, 2017 BL 426697 (N.D. Cal. Nov. 28, 2017).

[4] *See* IRS Request for Proposal, 2032H8-20-R-00500, available at https://aboutbtax.com/TKm. *See also* Joshua Mapperson, *The IRS offers a $625,000 bounty to anyone who can break Monero and Lightning*, CoinTelegraph (Sept. 11, 2020), available at https://cointelegraph.com/news/the-irs-offers-a-625-000-bounty-to-anyone-who-can-break-monero-and-lightning.

[5] IRS News Release IR-2019-167 (Oct. 9, 2019).

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One need not look further than the success of the IRS's Offshore Voluntary Disclosure Program (OVDP). Launched in 2009, OVDP netted some $11 billion in back taxes, interest, and penalties from over 50,000 participating taxpayers. It was created for a number of reasons; namely, its predecessor program was overly punitive, and it created distrust that contributed to lost tax revenues abroad, with some estimates as high as of $150 billion. Other motivations included recouping tax revenues (collections), promoting awareness, and increasing foreign bank account reporting compliance. OVDP closed in 2018. At closing, the IRS noted that advances in third-party reporting improved, awareness of tax obligations increased, and collections were very successful. These same themes are present with crypto compliance, maybe more so.

RECENT CRYPTO LEGISLATION BY CONGRESS AND THE UTILZATION OF AMNESTY

There are over 30 Congressional pieces of proposed crypto/blockchain legislation. Some ground-breaking, like the Digital Taxonomy Act[6] and Blockchain Innovation Act.[7] But these proposals address issues of regulatory frameworks, implementation of blockchain technologies, and thwarting digital criminal activities. None address crypto-tax compliance. Two proposed laws were on the right track but still fell short.

The Taxpayers with Forked Assets Act of 2019[8] would establish a safe harbor from IRS penalties for those who receive additional cryptocurrency from a hard fork, and the Virtual Currency Tax Fairness Act of 2020[9] would exclude up to $200 of tax gain from the sale of virtual currency in a personal transaction. Its reasonableness is apparent on its face — where, arguably, the IRS's "crypto as property" position could result in a capital gain on a stick of gum. But still, not one dealt with the elephant in the room — how to enforce overall crypto tax compliance and how to enforce it fairly and proportionately.

This is where amnesty starts to make sense. The silence by Congress leaves the matter open to the IRS. If the mission of the IRS has any meaning, "... helping [taxpayers] understand and meet their tax responsibilities and enforce the law with integrity and fairness to all,"[10] then ICAP sits squarely within that mission. Consider the numbers and demographic.

Approximately 15% of American adults now own cryptocurrency.[11] Given that nearly 160 million IRS Form 1040s will be filed in 2020, that equates to some 24 million 1040s that should bear some crypto reporting. And large dollars are in play. U.S. crypto assets before this year totaled about $111 billion and added another $67 billion of new investors this year. But more importantly, Millennials (26 to 40 years old) were *by far* the largest group of consumers buying cryptocurrency, some 57% of all consumers.[12] That equates to some 13.7 million Millennial tax returns that should disclose cryptocurrency positions and transactions.

One reason these statistics are important is awareness and experience. Of all groups, from Generation X to Baby Boomers, Millennials are likely the least experienced taxpayers. Contrast Millennials with those taxpayers engaging in foreign bank account nondisclosures of year's past, and the sophistication level is much lower. Yet, amnesty was offered to the more sophisticated (FBAR filers), but not those least likely to fully understand their reporting and compliance obligations — with the added disadvantage of crypto being an "emerging area." In effect, more is expected of the less equipped.

MILLENIALS AS TAXPAYERS AND CRYTPO INVESTORS

The IRS has also done less to educate Millennials. The FAQs for the disclosure of foreign bank accounts is fraught with explanations over penalties, going as far as detailing dollar amounts and statutes. The IRS's "*Frequently Asked Questions on Virtual Currency Transactions*," with its published 45 FAQs, makes not one mention of penalties.[13] More information and more education are offered to the more sophisticated — leaving the least tax savvy of the bunch, the Millennials, searching sites like Reddit for authoritative tax sources and a better understating of tax omissions and IRS penalty structures.

Millennials need tax help. A 48-page Government Accountability Office (GAO) Report, published in February 2020, noted several areas of improvement needed to increase cryptocurrency tax compliance and the present failings of the IRS.[14] The GAO points out that more is needed to help crypto users comply with

[6] H.R. 2154, 116th Cong. (introduced Apr. 9, 2019).

[7] H.R. 8153, 116th Cong. (introduced Sept. 1, 2020).

[8] H.R. 3650, 116th Cong. (introduced July 9, 2019).

[9] H.R. 5635, 116th Cong. (introduced Jan. 16, 2020).

[10] *See* IRS, The Agency, its Mission and Statutory Authority.

[11] Ron Shevlin, *The Coronavirus Cryptocurrency Craze: Who's Behind The Bitcoin Buying Binge?* Forbes (Jul. 27, 2020).

[12] Ron Shevlin, *The Coronavirus Cryptocurrency Craze: Who's Behind The Bitcoin Buying Binge?* Forbes (Jul. 27, 2020).

[13] *See* https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.

[14] U.S. GAO, Virtual Currencies: Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance,

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the tax laws. Namely, the GAO Report highlights that current cryptocurrency guidance, its Notices and FAQs, are *not* authoritative. Surprisingly, taxpayers cannot (*legally*) rely on current guidance in the preparation of tax returns. Moreover, accurately reporting all cryptocurrency transactions is unduly burdensome due to very limited third-party reporting. Both shortcomings are rightfully spelled out in the GAO Report.

Upon disposition, crypto users are expected to report each transaction, knowing its cost basis and fair market value at the time the cryptocurrency is exchanged. This is very challenging for those engaging in multiple transactions across multiple exchanges without any third-party reporting. Currently, only two of the nine major U.S.-based cryptocurrency exchanges have policies on third-party reporting. The IRS's own forms are lacking too. IRS information returns, IRS Form 1099-K, Form 1099-B, and Form 1099-Misc, do not have boxes covering cryptocurrency but they do for FATCA and even Fishing Boat Proceeds. The lack of "authoritative" guidance, shortcomings on IRS forms, and the absence of third-party reporting, makes accurate tax reporting doubly difficult for Millennials — coupled with the fact that largely 20 year old's have little to no experience with concepts of adjusted cost basis and rooting out the fair market value of transactions.

IRS TAXPAYER BILL OF RIGHTS AND AMNESTY

Some form of crypto amnesty is also consistent with the IRS Taxpayer Bill of Rights.[15] Taxpayers, here mostly Millennials, have the Right to be Informed (#1), the Right to Pay No More than the Correct Amount of Tax (#3) and the Right to a Fair and Just Tax System (#10). The lack of authoritative guidance makes it difficult to know (exactly) what a taxpayer needs to do to comply with the tax laws. The current IRS notices and forms are incomplete and are not controlling or binding on the IRS. They fail in regard to being "clear explanations of outcomes" (Right to Be Informed).

The potential for miscalculation is high too (especially among Millennials) because of the lack of consistent and reliable third-party reporting. This may result in a young taxpayer paying more of an "amount of tax legally due" (Taxpayer Right #3). Further, fairness dictates that our tax system consider "facts and circumstances that might affect [a taxpayer's] underlying liabilities ... or ability to provide information timely." This is precisely the reason crypto amnesty now makes sense. Not only does it satisfy the IRS's goals of reducing the crypto tax gap, increasing awareness and compliance, it is also fair and just (Taxpayer Right #10) — especially considering the demographic of crypto users.

There are still more reasons amnesty makes sense, unrelated to demographics. First, because of its novel privacy characteristics, rooting out bad actors is more difficult than in other contexts. However, amnesty may narrow the playing field. The crypto population coming forwarding, presumably, will be those with less to hide. Then, after the disclosures of good-faith taxpayers, the field is narrowed potential bad actors. This allows the IRS to better use its limited resources in apprehending illegal activities.

Second, the criminal activity associated with cryptocurrency, even privacy coins like Monero, may be a bit overstated. Consider this, in 2020, the average number of Monero transactions averaged about 10,000 per day. Monero recently traded at $110. Assuming — unrealistically — that every single Monero transaction was linked to illegal purposes, it takes Monero more times than the average calculator will compute to even compete with the amount of "dollars" used in illegal activities (reports estimate that banks process $2 trillion "dollars" in transactions linked to illegal activities).[16] This type of data suggests there is more to be gained by working with Monero, to learn from it, rather than focus on beating it. Monero has features to opt into transparency and the IRS is better served learning how those features work. That way, the IRS can educate privacy coin users on why transparency promotes the administration of the tax laws (and why doing so is in their best interests).

Distrust is what the IRS should seek to avoid. Ultimately, distrust underlaid the necessity of the OVDP program. The same dangers reside here. The IRS has poured its efforts into enforcement, not cooperation, and not education of the least educated bunch. Surprise examinations and penalty assessments against that backdrop is unnecessarily punitive. Millennials may understand simple IRS Form 1040s perfectly well, but may not be savy as to the taxation of hard forks and airdrops, and the nuances of adjusted basis, carry-over basis, and stepped-up basis. Yet, ICAP checks "the box" on all operational objectives — if the collection of tax dollars hidden from the IRS, awareness, and compliance are true goals of the IRS.

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available at https://www.gao.gov/assets/710/704573.pdf.

[15] *See* IRS Taxpayer Bill of Rights, https://www.irs.gov/taxpayer-bill-of-rights.

[16] *See* Stephen Gandel, *U.S. banks handled trillions of dollars in "suspicious" transactions, report says*, CBS News (Sept. 21, 2020). *See also* Monero Transactions historical chart, available at https://bitinfocharts.com/comparison/monero-transactions.html.

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CONCLUSION

IRS silence on amnesty speaks volumes but it does not solve the problem — neither does enforcement only. Crypto users, Millennials in particular, know the crypto space better than the IRS. They are smarter in decentralized environments and will run and hide in a space that is easy to run and hide to. Unlike OVDP, there are no centralized banks to pressure (like through FATCA). And like the necessity for OVDP, distrust lends to disappearance. Bitcoin was birthed from distrust of governments and centralized power. In this regard, more distrust will be the IRS's failing. Now is the time to build a bridge, not bomb it.

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