

Got Unreported Cryptocurrency Income? Mount A Defense

By **Michael DeBlis** (May 29, 2018, 4:52 PM EDT)

On Feb. 23, 2018, the digital currency exchange Coinbase Inc. informed a group of around 13,000 customers that it would be turning over their user records to the Internal Revenue Service in response to the agency's court order. This decision represents a major policy change on Coinbase's part, as it had previously refused to share its customer information. Even if you're not among the 13,000 affected customers, owning cryptocurrency means you may well be exposed to IRS scrutiny in the near future.



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United States v. Coinbase

The court order that finally prodded Coinbase into reluctant compliance is only the latest stage in a pitched legal battle between that company and the IRS. The IRS originally served a summons on Coinbase demanding nearly all of its customer records from the past several years. Coinbase refused to comply with the summons, leading to a flurry of motions and some heated discussion between the two parties before the U.S. District Court. Finally, after the IRS narrowed the scope of its summons to the aforementioned 13,000 or so customers, the court chose to support the reduced version of the IRS' summons. The court declared that it "serves the IRS' legitimate purpose of investigating Coinbase account holders who may not have paid federal taxes on their virtual currency profits."

Cryptocurrency and Taxes

The IRS' determination to seize Coinbase customer records is based on the agency's belief that a large percentage of cryptocurrency owners have not reported or paid taxes on their profits. And indeed, what public information exists suggests that the IRS is correct in its belief. For example, a 2017 survey by LendEDU found that more than a third of the respondents were deliberately planning to leave their bitcoin transactions off their tax returns.

According to the IRS, cryptocurrency investors must treat their profits as capital gains and pay taxes accordingly. Anyone who receives cryptocurrency as wages or other compensation must report it as income. And cryptocurrency miners are required to report their earnings as business revenue.

Taxpayers who deliberately fail to report these transactions are committing tax fraud, a serious offense that could result in a penalty of up to 75 percent. In other words, if the IRS charges your client with willfully failing to report \$10,000 worth of cryptocurrency income, your client could be skating on thin ice as he could be hit with a penalty of \$7,500 in addition to the original taxes owed, plus interest. On the other hand, a client who fails to report cryptocurrency income out of ignorance or carelessness, should be able to escape the proverbial "rack and thumbscrew" as this is considered negligence rather than fraud. This carries a penalty of 20 percent — still steep, but considerably better than the penalty for tax fraud.

At-Risk Cryptocurrency Holders

If you represent a client with unreported cryptocurrency income, it is best to be upfront and direct with your client when it comes to explaining the consequences, no matter how uncomfortable it might be. The stakes are high. Your client may be at risk for an audit or even for criminal investigation from the IRS. Prosecution for tax fraud, while rare, is very serious. The IRS and the U.S. Department of Justice are not patsies. Pursuant to their enforcement paradigm of maximizing the deterrent effect by making examples out of certain individuals — with celebrities, high net worth earners and individuals who hold professional licenses heading the list — they will not think twice about prosecuting those who willfully violate the tax laws. Given the IRS' obvious interest in cryptocurrency holders, it's likely that the agency will launch at least a few criminal

investigations in the near future.

The cryptocurrency holders with the highest risk at present are the 13,000 or so Coinbase customers whose records were recently turned over to the IRS. Most of these customers can expect an IRS audit and a small percentage will likely face criminal prosecution. If your client received a letter from Coinbase saying that their records have been turned over to the IRS, you should conduct a risk assessment to determine what, if any, options exist for bringing your client into compliance and explain to them the pros and cons of each.

Other cryptocurrency holders who should be particularly concerned include those who used cryptocurrency for purposes of laundering the proceeds of criminal activities, those who used cryptocurrency to hide income or assets from the IRS, those with particularly high cryptocurrency income or capital gains and anyone who receives a substantial percentage of their income from cryptocurrency.

The worst thing a person who falls within one or more of these groups can do at this point is nothing. Pretending that the IRS doesn't exist is as naïve as someone thinking they will get away with robbing a convenience store after dark even though they are wearing a work uniform with their name stitched across the front — it won't make the agency disappear or forget about the taxpayer. The best advice for a person who finds themselves ensnared in the coils of the IRS is to speak with a tax expert and find out their options so that they can make a well-informed decision. In most cases, heading the IRS off at the pass by voluntarily reporting past cryptocurrency gains and paying the required taxes on that income will be the taxpayer's best bet. However, before taking any steps in this direction, the client must understand the consequences they face if they come clean.

Civil v. Criminal Cryptocurrency Risks

Cryptocurrency holders whose conduct hovers closer to the willfulness end of the spectrum may be faced with criminal charges. As such, they should be especially cautious about taking action. Of course, a person can't be sure whether or not they run the risk of being charged without speaking with a tax attorney, preferably one with experience in criminal tax cases. In fact, such a person would be wise to speak with an attorney before speaking with their accountant or other tax adviser.

Accountants and enrolled agents do not enjoy the protection of attorney-client privilege. In criminal matters, such a tax adviser could be required to testify against the client. Fortunately, there's a way to avoid this particular trap. In what's called a Kovel arrangement. In a Kovel arrangement, the client discloses everything to their attorney and the attorney then turns around and hires an accountant to consult on potential tax issues. Because the accountant is working for the attorney rather than directly for the client, his work will be shielded under the umbrella of the attorney-client privilege.

If you determine that your client faces a significant risk of criminal prosecution, the voluntary disclosure program is likely the best way to get your client out of danger. Voluntary disclosure likely won't help much in getting rid of those formidable IRS penalties but at least a timely disclosure will help reduce the likelihood of your client becoming the next cooked goose to grace the IRS Thanksgiving table. If your client's cryptocurrency purchases are considered foreign assets, you'll need to prod your client to move quickly — the IRS' offshore voluntary disclosure program is in the process of shutting down. It will come to an end by Sept. 28, 2018.

When it comes to voluntary disclosure, be aware that your client is only eligible to make a voluntary disclosure if said disclosure happens before the IRS launches a criminal investigation against your client. The metaphor that I like to use here is the hunting of a fox by a bloodhound. If the bloodhound has already detected the scent of the fox and is hot on his trail, then the fox is "squat." Indeed, no amount of pleading with the bloodhound is going to save the fox.

If a prospective client is the subject of an IRS audit that is headed in a dangerous direction, he or she should engage legal counsel immediately.

Filing a Qualified Amended Return

There is no one size fits all remedy for becoming compliant. While voluntary disclosure might be the obvious choice for one client, it may be unnecessary for another. This is why a risk assessment must take into consideration an individual's unique facts and circumstances. For example, if the needle on the willfulness spectrum swings closer to the negligence end than the willfulness end, such that the risk of criminal

prosecution is slim to remote, a qualified amended return, or QAR, may be the more appropriate option. QARs can be particularly helpful in this type of situation because they allow the taxpayer to dodge the accuracy-related penalty for under-reported income. However, the taxpayer must file their QAR before they receive an audit notice from the IRS or else they'll miss out on the chance to escape the penalty.

If your client chooses to file a QAR and insists on doing the preparation work themselves, they must be very careful to complete the return accurately. For this reason, no matter how determined your client might be, you must convince them to engage a professional tax preparer. Filing an inaccurate QAR will make a bad situation that much worse, as it will likely lead to increased IRS scrutiny. If your client doesn't have access to the records or information they need to complete a 100 percent accurate QAR, that is even more reason to engage a professional tax preparer or to at least consult with a tax adviser to see if the records can legitimately be reconstructed through alternative sources. The accountant may even know of a better option.

As time passes, the risk of IRS scrutiny will only get worse for taxpayers with cryptocurrency investments or income. Even if your client believes they've accurately reported all of their cryptocurrency profits, you should convince them that there is no substitute and no shame in having a tax expert with experience in cryptocurrency conduct a thorough and comprehensive review. A completely innocent error could have major repercussions a year or two down the line. And if the client concedes to having failed to report cryptocurrency income or capital gains at the onset, the best interests of your client are served by having "the talk" — before the IRS comes knocking and slams the door shut on your client's failsafe option: voluntary disclosure.

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