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Cryptocurrencies and the IRS: What you need to know

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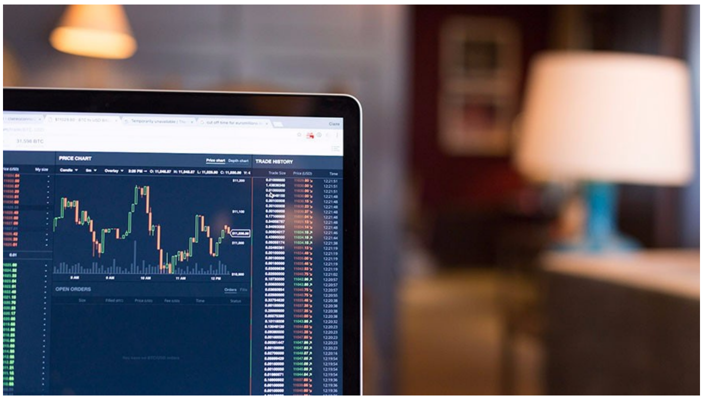

For a number of years, US taxpayers have invested in a variety of convertible virtual currencies also referred to as CVCs – cryptocurrencies being forms of CVCs that use cryptography – not always certain of the tax treatment of such investments. The Internal Revenue Service issued guidance in 2014 that briefly summarized the IRS's view that CVCs constitute "property" for US tax purposes so that in many circumstances transactions involving CVCs would give rise to a taxable gain or loss.

Many taxpayers struggled to understand the tax implications of purchasing other assets with CVCs, exchanging one form of CVC for another form of CVC, "hard forks", airdrops and other transactions, whether they are a dealer or an investor, and/or whether the ownership of the CVCs gives rise to a requirement to file Forms 114 or 8938. With a change to section 1031 as part of the 2017 Tax Cuts and Jobs Act, the IRS has even more to gain by going after taxpayers who invest in the crypto space.

Some taxpayers reported their CVC transactions on timely filed income tax returns. Many taxpayers, however, did not do so. Perhaps you or your client are one of them.

Recent communication from the IRS on CVC investments

The IRS has begun to focus on CVCs including cryptocurrencies in general, potentially noncompliant taxpayers, and the perceived lack of proper reporting by taxpayers. For example, some time ago, the IRS was able to obtain information on some 13,000 customers from Coinbase.

The IRS recently announced in an Information Release that it has sent or will be sending out letters to some 10,000 taxpayers informing them that they have or had accounts containing CVCs but may not have properly reported and paid tax on transactions involving those CVCs. One letter (Letter 6174) is being sent to taxpayers whom the IRS believes have or had CVCs but may not have known that transactions involving CVCs should have been reported, while a second letter (Letter 6174-A) is being sent to taxpayers whom the IRS believes have not properly reported their CVC transactions. In both cases, the taxpayers are being urged to review their transactions and file either amended or delinquent tax returns (with the name of the letter written on page one of the tax return).

The third letter (Letter 6173) is being sent to taxpayers whom the IRS believes have not met their filing and reporting obligations, and whom are directed to either contact the IRS by the date set out in the letter and explain why the taxpayer believes it has properly complied with the applicable filing and reporting requirements, or file delinquent or amended tax returns properly reporting the CVC transactions. Note that the amended or delinquent returns are not filed with the IRS Office you typically file your tax returns with, but rather a special IRS office in Philadelphia, PA, indicating specialized attention to the issue.

What should letter recipients do?

Tip 1

Take the letters very seriously, particularly Letter 6173 since that letter requires a response by a specific date.

Tip 2

Work with both an accountant and an attorney who have experience with CVCs as well as with IRS investigations. The responses to Letter 6173 setting out why you believe that you have complied with the applicable filing and reporting requirements has to be signed under penalties of perjury and acknowledging that the IRS will cross check the information you provide against information it has received from banks, financial advisors and other sources. You do not know what information the IRS already has to confirm whether your submission is accurate, so we recommend you ensure that any submissions are complete and accurate. Note that in many cases banks and other financial institutions cannot tell you that they have been contacted by the IRS nor can they tell you what information they may have provided the IRS.

Tip 3

We recommend your attorney retains your accountant under a Kovel letter arrangement to ensure that communications between you and your advisors are privileged and confidential. This will allow you to have a full and frank discussion about your CVC transactions with your advisors. You should discuss with your accountant and attorney the limitations to a Kovel letter arrangement.

Tip 4

Act now and do not ignore the letters because you are busy or find the task of responding to be overwhelming, even if you only received Letter 6174 or Letter 6174-A which do not have a “Reply By” date. You should expect that if you do nothing, at some point you will receive additional correspondence from the IRS. Ignoring the IRS letter will not make the problem go away.

Tip 5

Don’t try and deal with the IRS by yourself and without knowledgeable advisors, particularly if you received Letter 6173. The tax treatment of CVC transactions can be very complicated and subject to different interpretations, and you should work with competent advisors with experience in this area. Again, you do not know what information the IRS has.

Tip 6

Although it may be your inclination, do not take the position that the IRS was incorrect in their 2014 Notice in treating CVCs as property so that you can therefore ignore the letters.

How we can help

Withers has a wealth of experience in tax planning and reporting in general, including in the unsettled area of CVC and cryptocurrency taxation. If you or your client has received a letter from the IRS about cryptocurrency investments or has legal or tax related questions regarding CVCs and cryptocurrencies, please contact Withers.

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