

Cryptocurrency – An Overview of IRS Enforcement Efforts to Ensure Compliance

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Virtual Currency

- **What is Virtual Currency?** Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like “real” currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction. *See* IRS Notice 2014-21.
- **What is Cryptocurrency?** Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger, such as blockchain. A crypto transaction recorded on the distributed ledger is an “on-chain” transaction; a transaction not recorded on the distributed ledger is an “off-chain” transaction. *See* Rev. Rul. 2019-24.

Notice 2014-21, March 25, 2014

- **Tax Consequences.** In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability.
- **“Property” for Tax Purposes.** Virtual currency is treated as property for U.S. tax purposes. General tax principles applicable to property transactions apply to transactions using virtual currency.
- **Gain/Loss.** The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer.
- **Information Reporting.** Payments made using virtual currency must be reported on Form 1099-MISC, using FMV of the virtual currency on date of payment.

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IR-2018-71, March 23, 2018

- IRS reminds taxpayers to report virtual currency transactions
- Taxpayers who do not properly report the income tax consequences of virtual currency transactions can be audited for those transactions and can be liable for penalties and interest.
- In more extreme situations, taxpayers could be subject to criminal prosecution for failing to properly report the income tax consequences of virtual currency transactions.

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FAQ on Virtual Currency Transactions, October 9, 2019

- IRS recently published a 43 question-and-answer FAQ on how taxpayers should report virtual currency transactions.
- **Holding Period** - Begins on day after taxpayer acquired virtual currency and ends on day of sale.
- **Cost Basis** - Basis in virtual currency is the amount spent (in U.S. dollars) to acquire the virtual currency, including fees, commissions, and other acquisition costs.
- **Calculating basis** in cryptocurrency received via (i) Peer-to-peer transaction, (ii) Exchange Platform (e.g., Coinbase), (iii) Hard fork, and/or (iv) Hard fork + airdrop.
- **Specific Identification vs. FIFO** - Taxpayers may specifically identify the unit(s) of virtual currency they sell or exchange for purpose of calculating gain/loss. If taxpayer does not specifically identify the specific units sold, should use first in, first out (FIFO) basis for determining gain/loss.
- **Gift Transfers** – If taxpayer receives virtual currency as bona fide gift, no recognition of income until taxpayer sells, exchanges, or disposes of virtual currency. Basis in gift depends on whether there is gain/loss upon disposition (if no documentation to substantiate donor's basis in virtual currency, taxpayer/recipient's basis is ZERO).

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Revenue Ruling 2019-24, October 9, 2019

- Guidance on how to report “hard fork” and “airdrop” cryptocurrency transactions.
- **“Hard Fork”** – when a cryptocurrency undergoes a protocol change or “split” resulting in a permanent diversion from the legacy distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger.
- **“Airdrop”** – an airdrop is a means of distributing units of cryptocurrency to the distributed ledger addresses of multiple taxpayers.
- **Hard Fork + Airdrop** – a hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency.
- **Tax Consequences.** A hard fork is not always followed by an airdrop. If a hard fork occurs, but the taxpayer does not receive units of a new cryptocurrency, then no gross income under IRC § 61. If hard fork occurs and taxpayer receives units of new cryptocurrency via airdrop, taxpayer has gross income under IRC § 61.

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Application of FinCEN Regulations to Virtual Currency

- A user of virtual currency is *not* an MSB under FinCEN's regulations and therefore is not subject to MSB registration, reporting, and recordkeeping regulations.
- However, an administrator or exchanger is an MSB under FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition applies to the person.
 - FIN-2-13-G001

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Title 31 Regulation

18 U.S.C. § 1960 – Operation of an Unlicensed Money Service Business

Businesses must be registered as a money transmitting business with the Secretary of the Treasury Department's Financial Crimes Enforcement Unit (FinCEN) as required by Title 31 U.S.C. Section 5330.

This applies to domestic and foreign based MSBs conducting substantial business in the United States.

Failure of administrators/exchangers to register as an MSB is usually a good indicator that the entity lacks knowledge of anti-money laundering requirements including the Funds Transfer and Funds Travel Rules.

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Virtual Currency Enforcement Specialist

- What is a FinCEN Virtual Currency Enforcement Specialist?
 - Analyze, research, describe, and assess financial institutions, or their partners, directors, officer, or employees, operating in convertible virtual currency for their compliance with the U.S. anti-money laundering/combating the financing of terrorism (AML/CFT) regulatory framework;
 - Conduct research and build compliance and enforcement cases and organize their supporting evidence, as well as analyze and prioritize targets based on FinCEN priorities;

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Virtual Currency Enforcement Specialist (2)

- Participate in the formulation, planning, development, and implementation of compliance and enforcement strategies related to virtual currency businesses that have industry-wide, national, or international impact, including those related to national security.
- Serve as a technical expert regarding cryptocurrency, blockchain analytics, and cyber intelligence gathering tools in order to produce sophisticated analyses, assess the darknet, and conduct blockchain analytics.

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IRS-CI Evolution on Virtual Currency

- IRS-CI formed a team in 2013 to study the use of virtual currencies to avoid taxes by moving money in and out of offshore accounts.
- IRS-CI is forming specialized teams with expertise to develop high-impact cases.

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Evolution of Virtual Currency (1)

- IRS-CI began looking into Virtual Currency in 2013
- At the time IRS-CI involved with a lot of Identity Theft Crimes (IDT) involving tax returns
- Those crimes evolved to Cyber IDT often times involving the dark web and virtual currency



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Evolution of Virtual Currency (2)

- **Cyber Crimes HQ Office:** Oversees the nationwide implementation of IRS-CI cybercrime programs. Develop policy, strategy and investigative support issues.
- **Cyber Crimes Units:** IRS-CI has two fully operational CCUs (Washington DC and Los Angeles) staffed with technology savvy special agents, investigative analysts, data/software engineers, computer investigative specialist, and other support personnel.
- **Field Office Cyber Coordinators:** CI has 21 Lead Cyber Coordinators in each of our 21 field offices.
- **Cyber Support Unit:** CI recently stood up a Cyber Support Unit with eight investigative analyst and one supervisory investigative analyst solely focused on supporting cyber investigations
- **National Cyber Forensic and Training Alliance:** IRS-CI assigned a CCU SA to act as a liaison officer at NCFITA Headquarters. This is a partnership between private industry, government, and academia for the sole purpose of identifying, mitigating, and disrupting cyber crime.

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Evolution of Virtual Currency (3)

- **European Cybercrime Centre:** A CCU special agent is assigned to the EC3 as a liaison officer in Netherlands.
- **Nationally Coordinated Investigations Unit:** An embedded unit within CI that is using Data Analytics to build typologies in various financial driven crimes to include cybercrime
- **Cyber Undercover Program:** IRS-CI launched a cyber undercover program to train cyber agents to conduct undercover operations online.
- **Cyber Fusion Team:** CI led coordination within IRS to share real-time intelligence from the Dark Web and other online sources.
- **Joint Chiefs of Global Tax Enforcement (J5):** In 2018, IRS-CI teamed up with tax authorities from the United Kingdom, Canada, Australia, and the Netherlands. The J5 are committed to combatting transnational tax crime through increased enforcement collaboration. The J5 will work together to gather information, share intelligence, conduct operations and build the capacity of tax crimes, money laundering and cyber crime enforcement.

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IRS-CI Priorities (Virtual Currency)

- Intersection of Cyber and Financial Crimes = Virtual Currency
- IRS-CI follows the digital money
- Pursuing tax (Title 26) and money laundering (Title 18) violations
- Crypto Kiosks
- Dark web marketplaces

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IRS Tracing Virtual Currency Transactions

- ***IRS Tracing “Anonymous” Bitcoin Transactions*** - IRC-CI is contracting with blockchain analysis services to create a path of transactions that may be followed through the Bitcoin blockchain to connect off-chain identities with Bitcoin addresses. *See e.g., [IRS Contract with Chainalysis](#)*
- In October 2019, the U.S. Attorney’s Office for the District of Columbia announced that IRC-CI had traced Bitcoin transactions to identify and takedown the largest child exploitation website on the darkweb. By analyzing the blockchain and de-anonymizing bitcoin transactions, the IRS was able to identify hundreds of predators around the world – despite the users’ likely assumption the Bitcoin transactions were anonymous. ([Link](#))

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Notable Investigative Highlights

- Liberty Reserve
- BTCe
- Silk Road I and II
- Alphabay
- In all investigations, CI was the lead agency in the cryptocurrency tracing and ultimately the attribution of main targets or the associated network servers.

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IRS Areas of Focus

Virtual currency tax compliance is an IRS priority.

- The IRS is focused on enforcing tax compliance for holders of virtual currency.
- Virtual currency is ongoing focus area for the IRS and IRS Criminal Investigation using all available compliance avenues:
 - examination
 - criminal prosecution
 - data analytics
- Compliance efforts are focused on enforcing the law and helping taxpayers fully understand and meet their obligations.
- Virtual currency is an asset and is treated as such in IRS examination and collection activities.
- Interviews with taxpayers now routinely include questions about virtual currency assets and transactions.

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Reporting Virtual Currency Transactions

- IRS Notice 2014-21 & Revenue Ruling 2019-24
 - states that virtual currency is property for federal tax purposes
 - provides guidance on how general federal tax principles apply to virtual currency transactions.
- Transactions in virtual currency should follow analogous property taxation rules.
- When applying these rules taxpayers should take positions that are reasonable and consistent.
- The IRS anticipates issuing additional legal guidance in this area.

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IRS Compliance Activities

- Current activities include
 - Guidance
 - Training
 - Communications and education
 - Coordination efforts

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Guidance

- Guidance for employees working cases involving virtual currency
 - Sept 2018 – Formed Collection Virtual Currency Team, tasked with developing policy and guidance on collection strategies
 - Ongoing – Guidance to Field Collection, summons guidance, IRM guidance
 - Communication efforts include a new section on internal website and articles in newsletters reaching CEASO, ATAT and International employees.
 - Coming soon: Additional guidance pending on levy, seizure and sale procedures, and glossary of terms.

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Training

- Training for employees working cases that involve virtual currency
 - New and revised training materials
 - CPEs
 - Each Field Collection Area selected a subject matter expert who received face-to-face training to be shared with ROs, advisers, PALS
 - Virtual Currency Toolkit



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IRS Educational Letters

- July 26, 2019 – IRS announced it began sending educational letters to taxpayers with virtual currency transactions (IR-2019-132)
- More than 10,000 taxpayers received letters.
- Three variations of the educational letter: Letter 6173, 6174 and 6174-A.
- All versions strive to help taxpayers understand their tax and filing obligations and how to correct past errors.

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IRS Educational Letters

- Letters advised taxpayers to review tax filings and when appropriate, amend past returns and pay back taxes, interest and penalties.
- Names of taxpayers were obtained through various ongoing IRS compliance efforts.
- Taxpayers are pointed to information on IRS.gov, including which forms and schedules to use and where to send them.



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Updated Forms and Publications

- Collection Information Statement (Form 433-A) updated to request information on virtual currency
- Instructions (Pub. 1854 and 5059) also updated

Section 3 Personal Asset Information

Use the most current statement for each type of account, such as checking, savings, money market and online accounts, stored value payroll card from an employer, investment, retirement accounts (IRAs, 401(k) plans), stocks, bonds, mutual funds, certificates of deposit and virtual currency (such as Bitcoin, Ripple, Ethereum, etc.). Life insurance policies that have a cash value, and safe deposit boxes. Asset value is subject to attachment, etc. based on individual circumstances. Enter the total amount available for each of the following (if additional space is needed include attachments).

Round to the nearest dollar. Do not enter a negative number. If any line item is a negative number, enter "0".

Cash and Investments (domestic and foreign)

Cash Checking Savings Money Market Account/CD Online Account Stored Value Card

<input type="checkbox"/> Virtual currency	Name of virtual currency wallet, exchange or digital currency exchange (DCE)	Email address used to set-up with the virtual currency exchange or DCE	Location(s) of virtual currency
Type of virtual currency			
Current market value in U.S. dollars as of today			
\$	X.X = \$		= (2c) \$
Total investment accounts from attachment (current market value minus loan balance)(k)			(2d) \$
Add lines (2a) through (2d) =			(2) \$

Catalog Number 55996Q www.irs.gov Form 433-A (OIC) (Rev. 3-2019)

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Coordination Efforts

- Within IRS
 - National Cryptocurrency Issue Team – works on virtual currency issues with cross-functional impact; coordinate strategies and share initiatives
 - Collection Virtual Currency (CVC) team working with IRS-CI, Collection, Counsel
- Other federal law enforcement

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Key Points

- Compliance efforts are focused on enforcing the law, educating taxpayers so they can meet their obligations.
- Taxpayers who do not properly report the income tax consequences of virtual currency transactions:
 - are, when appropriate, liable for tax, penalties and interest.
 - In some cases, could be subject to criminal prosecution.
- IRS anticipates issuing more legal guidance in this area in the near future.
- More information: IRS.gov, search “virtual currencies”

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Mr. Villa's practice concentrates on resolving federal tax controversies and white collar crime such as securities, tax and bank fraud. He represents individuals, closely-held businesses, and large corporations in IRS audits, appeals, and litigation. Mr. Villa represents individuals and entities in business disputes and lawsuits involving fraud, breach of contract, breach of fiduciary duty, deceptive trade practices act violations, non-compete violations, business torts, and other commercial disputes.

In 2010-2013, Mr. Villa was named a Texas Rising Star, and in 2013-2014 he was named a Texas Super Lawyer as listed in *Texas Monthly* and *Texas Super Lawyer Magazine*, and on the web at superlawyers.com.

Prior to joining the firm in 2007, he worked in Washington, D.C. as a Congressional intern to U.S. Senator John Breaux (Retired) and worked as an Associate with a regional law firm in New Orleans, Louisiana. In 2004-2005, he served as a Judicial Clerk to the Honorable James J. Brady, U.S. District Court, Middle District of Louisiana.

Mr. Villa was admitted to practice in Louisiana in 2004 and in Texas in 2005.

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