The IRS recently announced new audit priorities that include an emphasis on virtual currency transactions. Individuals who have concerns about the virtual currency transactions reported on their prior tax returns should seek immediate guidance.

On July 2, 2018, the IRS announced five new tax enforcement campaigns, one of which focuses on virtual currency. Over the last 18 months, the IRS has shifted towards issue-based audits, which it refers to as “campaigns.” The IRS has previously stated that it identifies audit campaigns after extensive data analysis, suggestions from IRS employees and feedback from the public. IRS campaigns permit the IRS, which currently has limited resources, to strategically deploy employees and focus audits on limited issues where it believes that it will obtain a significant return based on its investment of time. Individuals who engage in transactions that have been listed as the subject of an IRS campaign have a high likelihood of being flagged for an audit.

Because virtual currency is not exchanged through traditional financial institutions, the typical warning signs about the federal and state tax implications of such transactions will not be apparent. For example, taxpayers will not typically be issued an IRS Form (such as a Form 1099) in respect of cryptocurrency transactions. As a result, many taxpayers fail to consider properly the income tax consequences associated with virtual currency transactions until well after they have filed their tax return.

The IRS’s position is that virtual currency is property, not currency, meaning that most virtual currency transactions are taxable events. See IRS Notice 2014-21. For example, a taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date on which the virtual currency was received. Also, the taxpayer transferring such virtual currency as payment for goods or services must recognize gain or loss equal to the difference between the transferring taxpayer’s cost basis in the virtual currency and the fair market value of the goods or services received. There could even be a payroll tax obligation on the transferor if the service provider is an employee of the transferor. Needless to say, the reporting and recordkeeping obligations imposed on taxpayers can be arduous if taxpayers are to report properly.

Furthermore, the mere exchange by a taxpayer of one type of virtual currency for another type of virtual currency is a taxable event, due to recent tax legislation under the Tax Cuts and Jobs Act of 2017, which removed the ability for taxpayers to take advantage of the tax-deferred “like-
kind exchange” rules on non-real estate transactions. For example, suppose T purchased Bitcoin for $1,000 in 2015. In 2018, T exchanges his Bitcoin for Ethereum. The market value of the Bitcoin at the time of the exchange in 2018 is $12,000. T must report a capital gain of $11,000 and pay tax on such gain even though T never received any U.S. currency.

Prior IRS campaigns have focused on international tax compliance with a heavy emphasis on individuals who send and receive money offshore as well as foreign individuals who transact business in the United States. Therefore, virtual currency transactions that also involve international transfers of U.S. dollars may be flagged.

Based on this newest campaign, the IRS’s enforcement efforts are likely to be focused on:

• individuals who redeem, transfer or exchange virtual currency;
• companies who pay individuals for personal services in virtual currency; and
• individuals who receive compensation in the form of virtual currency for providing personal services.

Individuals who use virtual currency and have concerns that they are not correctly reporting these transactions should seek advice from an attorney or certified public accountant.

If the unreported transactions are substantial, the IRS has a voluntary disclosure program that permits individuals and companies who have failed to report substantial amounts of taxes to amend prior tax returns and potentially receive penalty abatements (or at least mitigate penalties) in exchange for stepping forward. Individuals who believe that they may need to enter the IRS voluntary disclosure program should seek legal counsel immediately. The program is not open to individuals or companies who are already selected for audit.

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