



**2020 Tax Expo**  
**TXCPA Houston**  
**Cryptocurrencies**  
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## Biography



Kevin Sweeney is an experienced civil and criminal tax controversy attorney focused on high-stakes IRS audits, voluntary disclosures, civil tax litigation, white-collar criminal defense, and whistleblower matters.

Kevin counsels companies and individuals on tax compliance matters and defends them in IRS audits and civil tax litigation. He draws on his experience at the U.S. Department of Justice's Tax Division (DOJ). Kevin's skill set is particularly suited for complex tax issues and sensitive tax matters where penalty, fraud, or criminal issues could arise.

Kevin is also a seasoned white-collar criminal defense attorney with a focus on criminal tax cases. As a former federal prosecutor, he has investigated and litigated dozens of federal white-collar criminal cases in United States District Courts throughout the country. Cases Kevin has litigated have been covered by Fortune, Bloomberg, and The Financial Times.

Kevin formerly served as a trial attorney with the U.S. Department of Justice Tax Division, where he was twice honored with the Department's Outstanding Attorney Award. During his tenure, he led many of its most significant cases including of offshore banking cases against Swiss banks BSI SA, Union Bancaire Privée (UBP) SA, and Edmond de Rothschild SA.

Kevin frequently speaks and writes on civil and criminal tax controversy and litigation matters and is often quoted by national media outlets including the Wall Street Journal, CNBC and CNN. He is admitted to practice law in New York, New Jersey, and Pennsylvania

## Origin of Cryptocurrency



- **Cypherpunk movement**
  - Privacy as a means of political and social change
  - Goal of creating a digital currency unaffected by desires of politicians and regulators
  - Early attempts failed to solve double spending problem
- **Bitcoin is born**
  - Satoshi Nakamoto white-paper published in 2008
  - First coin is generated several months later in 2009
  - Valued in 2010 when 10,000 BTC (\$70 million today) exchanged for 2 pizzas
- **Wild, wild west of crypto (2011-2016)**
  - Rival cryptocurrencies emerge
  - Fraud and hacks run rampant
  - Privacy features exploited by participants in unlawful activities
  - Huge market valuations and fluctuations
- **Crypto enters mainstream**
  - Bitcoin hits \$10,000 in 2017
  - Global crypto market cap currently sits at about \$300 billion
  - Over 2,000 types of cryptocurrencies

## What is Cryptocurrency?



- Digital representation of value that functions as medium of exchange, unit of account, and/or store of value and uses cryptography to secure financial transactions, control creation of additional units, and verify transfer of assets.
- **Unit of account**
  - Virtual coin
  - Electronic file that does not exist in physical form
- **Secured with cryptography**
  - Method for creating and protecting information/communications with codes
- **Each coin contains digital encryption key pair**
  - Public key – cryptographic code that allows users to receive coins
  - Private key – cryptographic code that allows users to control coins

## What is the Blockchain?



- **Crypto's record-keeping technology**
  - Digital ledger (database) that keeps track of peer-to-peer crypto transactions
  - Groups of transactions are recorded in units called blocks
  - New blocks are sequentially added to form chain
  - Blockchain is immutable
  
- **Decentralized**
  - Blockchain is publically shared and synchronized
  - No central administrator
  - Not controlled by any sovereign or regulators
  - Not dependent on intermediaries such as banks
  
- **Pseudo-anonymous**
  - Transparency of transactional history instills trust in the system
  - Encryption protects the privacy of transaction participants

## Role of Crypto Miners



- **Network of independent persons who validate and create crypto**
  - Use powerful computing power to run computer software (nodes)
  - Sometimes groups of miners pool computing power (mining pools)
  
- **Mining process validates transfers of crypto by consensus**
  - Transactions broadcasted to network of miners
  - Nodes collect transactions into blocks
  - Attempt to solve math puzzle called proof of work (POW) for each block
  - Checked against other pending transactions to ensure no double spending
  
- **Mining process creates new coins**
  - Miners are incentivized to solve POW with standardized awards of new BTC
  - One new block is created and timestamped every 10 minutes
  - Only one miner will solve each POW
  - Amount of newly created BTC is controlled by this protocol

## Crypto Wallets



- **Devices that allow users to store and/or transact crypto**
  - Physical wallets
  - Digital wallets
- **Cold vs. hot storage**
  - Physical vs. USB-like
  - Desktop vs. web-based
- **Personal vs. exchange-based wallets**
  - Fungible vs. non-fungible
- **User habits**
  - Coin compatibility
  - Security
  - Multiple wallets

## Cryptocurrency Transactions



- **Methods of acquiring crypto**
  - Mining
  - ATMs
  - Initial Coin Offerings (ICOs)
    - Security vs. Utility tokens
  - Hardforks/Air Drops
- **Other ways crypto is transacted**
  - Exchanging Cryptocurrency and property (i.e. Barter)
  - Exchanging Cryptocurrency and Sovereign (fiat) currency
  - Exchanging Cryptocurrency and Cryptocurrency

## Cryptocurrency Marketplace



- **Peer-to-Peer transactions**
  - Particular coins transferred directly from one person to another
  - Wallet permits private key holder to transfer coin to other wallets
  - Transaction is recorded in blockchain
  - New private key is generated and provided to recipient of coin transfer
- **Crypto exchanges**
  - Decentralized v. centralized
  - Non-custodial vs. custodial
  - Most centralized, custodial exchanges operate off-blockchain (Coinbase)
  - Off-blockchain crypto transactions are not pseudo-anonymous

## Why Does Crypto Have Value?



- **Limited supply**
  - Only 21 million bitcoins will be created
- **Divisibility**
  - Divisible by .00000001 (known as a Satoshi)
- **Easily transacted**
  - Portable and easy to buy and sell
- **Secure**
  - Immutable and transparent
- **Durable**
  - Non-consumable

## IRS Notice 2014-21 – General Principles



- **IRS considers crypto to be property**
  - Not currency
  - Does not indicate what type of property (ie. intangible, security, commodity)
- **Any transaction has potential to trigger gain or loss**
  - Gain or loss calculated based on FMV of crypto on date of payment or receipt
  - No *de minimus* exception (purchase of cup of coffee generates gain or loss)
  - Treatment of gain or loss depends on whether held as capital asset

## Computing Gain or Loss



- **Notice 2014-21 states that general tax principles apply**
  - Specific identification is only basis method for general property (Treas. Reg. 1012)
  - Practical issue of accounting for myriad of small fractions of coins (especially miners)
  - Legal issues of identifying fungible crypto and valuing peer-to-peer transactions
- **IRS October 9, 2019 FAQ - Valuation**
  - FMV is amount recorded by crypto exchange for transaction in U.S. dollars
  - If not recorded by exchange, then FMV per blockchain explorer that analyzes worldwide indices of a cryptocurrency and calculates value at exact date and time
- **IRS October 9, 2019 FAQ – Identification**
  - Key and address information showing purchase and sale price of specific coin; or
  - Wallet records showing all transactions for all units of a specific virtual currency
  - Must show:
    - (1) Date and time each unit was acquired;
    - (2) Basis and the fair market value of each unit at the time it was acquired;
    - (3) Date and time each unit was sold, exchanged, or otherwise disposed of; and
    - (4) Fair market value of each unit when sold, exchanged, or disposed of
  - Otherwise FIFO is permissible

## Charitable Contributions and Gifts



- **Charitable contributions**
  - No income, gain, or loss is recognized
  - If held more than 1 year, deduction is equal to FMV at time of donation
  - If not, lesser of basis or FMV at the time of the contribution
- **Gifts**
  - No income tax upon receipt
  - Gift receiver inherits holding period of gift giver (if substantiated)
  - For gain determination, receiver inherits donor's basis plus any gift tax
  - For loss determination, lesser of donor's basis and FMV
  - If no substantiation, basis of zero

## Mining Income



- **Bitcoin awards**
  - Reportable as ordinary income
  - Awards earned from hobby are reportable as "other income"
  - Awards earned from business reportable on schedule c (or other legal entity return)
  - SE tax consequences to hobby vs. business
- **Gains from mined bitcoin**
  - Ordinary income amount becomes basis of mined coins as capital asset
- **Mining pools (often limited information)**
  - Partnership?
  - Rental income?
- **Typical expenses (can generate gains when purchased with crypto)**
  - Mining equipment
  - Internet Fees
  - Utilities (electricity)

## Businesses Accepting Crypto



- **Receipt of cryptocurrency as payment**
  - Report FMV of crypto as gross receipt when received
  - Subsequently report gain or loss on disposition (if held)
- **Cryptocurrency for services**
  - Self employment and other employment tax considerations
  - Cryptocurrency payments:
    - Remuneration for services: Form W-2
    - For contractors: Forms 1099 and 1042
  - Cryptocurrency payments and back-up withholding/TIN requirement
- **Third-party settlement organizations (TPSO)**
  - Third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and customers
  - Form 1099-K issued if:
    - \$20,000 of gross proceeds; and
    - More than 200 transactions
  - Application to crypto exchanges?
  - Form 1099-B more appropriate (implication of bitcoin futures)?

## Reporting Hard Forks



- **Rev. Rul. 2019-24 (October 9, 2019)**
  - Scenario 1 - Taxpayer receives no airdrop following the hard fork
  - Scenario 2 – Hard fork includes airdrop to taxpayer
- **Scenario 1**
  - Taxpayer does not have gross income as a result of a hard fork b/c did not receive units of a new crypto
- **Scenario 2**
  - Taxpayer recognizes ordinary income from hard fork generating airdrop
  - Income recognized when airdropped crypto received into wallet
  - Recognized amount equals FMV of new crypto at time of receipt



### Many Questions Still Remain



- **Gains subject to 3.8% net Income tax?**
- **Pre-Tax Cuts and Jobs Act of 2017 Issues?**
  - Like-Kind Coin-for-Coin Exchanges
  - Theft or Casualty Loss
- **Initial Coin Offerings (ICO)?**
- **Wash Sales?**
- **Straddle Rules?**
- **Mark-to-Market?**

### Foreign Information Reporting



- **FBAR/Form 8938 requirements for foreign wallets?**
  - Alleged FinCEN/IRS statements indicating no requirement
- **Personal wallets provided by foreign companies**
  - Probably not reportable
  - Analogous to holding gold in a safe deposit box
- **Foreign exchange-based wallets**
  - Perhaps
  - Argument could be made it is analogous to gold fund shares in foreign account

## IRS Crypto Initiatives



- **IR-2018-71 reminds taxpayers - March 2018**
  - Taxpayers may be audited and liable for penalties
  - Can be prosecuted in extreme circumstances
- **LB&I campaign announced - July 2018**
  - Addresses noncompliance related to use of virtual currency through outreach and examinations
- **Criminal task forces**
  - IRS-CI International Tax Enforcement Group
  - Joint Chiefs of Global Tax Enforcement (J-5)
- **Revised Schedule 1 to Form 1040 for 2019**
  - “At any time during 2019, did you receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?”

## IRS Data Mining



- **Coinbase John Doe summons**
  - Summons for a class of people then unknown
  - Despite Coinbase boasting of thousands of US clients, only 802 reported tax
  - Coinbase notified 13,000 customers in February 2018 that their account records will be turned over to IRS
- **Bitfinex FATCA announcement**
  - Announced that it will be performing FATCA due diligence procedures
  - Asked clients to certify U.S. status
  - Informed clients it would be providing information to BVI and, in turn, IRS
- **Form 1099-K information reporting**
  - CP2000
- **Targeted IRS notices (6173, 6174, 6174-A, CP2000)**
  - 6173 - File tax returns or certify compliance under penalties of perjury

## Criminal Schemes



- **Covert Repatriation of undeclared offshore funds with crypto wallets**
- **Tumblers**
  - Services designed to disguise participants of on-chain crypto transactions
- **False account information**
  - Crypto exchanges have historically had lax KYC standards
- **Schemes to divert business receipts to unreported crypto wallet**
  - New form of skimming
- **Evasion of payment**
  - Conversion of seizable assets into crypto
- **False invoice schemes**
  - Internal wallet transfers disguised as business expenses
- **Industry professionals/primary source of income**
  - Miners

## Addressing Historical Noncompliance



- **Qualified amended returns**
  - Takes the place of original tax return
  - Eliminates accuracy-related penalty exposure
- **Voluntary disclosure**
  - New program provides little penalty benefits
  - Generally six years of amended returns
  - Generally 75% fraud penalty for highest year
  - Generally only appropriate for taxpayers with significant criminal exposure
- **Quiet disclosure**
  - Sole option for Coinbase John Doe summons class members
  - New IRS guidance indicates appropriate for some taxpayers
  - Lack of clear guidance from IRS provides ammunition for reasonable cause

Questions?



Thank You!