Client Alert

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Cryptocurrency Exchanges – the New Front of the IRS War on Tax Evasion?

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On November 29, 2017, the U.S. District Court for the Northern District of California dealt a partial blow to the U.S. Department of Justice and the IRS in connection with their collective efforts to enforce an expansive and overly broad "John Doe summons" request in relation to the customers of Coinbase Inc. (“Coinbase”). Coinbase is the largest cryptocurrency exchange in the United States and the fourth largest in the world. The narrowed court order represents an important victory for Coinbase and its customers, and sets a generally favorable precedent for other cryptocurrency exchanges that may face similar informational requests in the future.

Under the Internal Revenue Code of 1986, as amended (the “Code”), the Internal Revenue Service (the “IRS”) can use extraordinary methods to obtain information from the taxpayer. Under Sections 7603, 7605, and 7609 of the Code, the IRS is authorized to issue summonses to compel taxpayers and third parties to provide information relevant to an audit. Such third parties include record keepers such as banks or other financial institutions and, in this case, a cryptocurrency exchange. A third party may hold critical information, and may not object to a summons simply because the audit does not pertain to its liability but can negotiate the scope of the summons, depending on the economic burden of complying with the summons. If necessary, the IRS can proceed to summons enforcement action in the appropriate district court to compel production of the information it is seeking.

Here Coinbase resisted the summons (after the IRS voluntarily narrowed its scope), and the IRS followed up with a summons enforcement action in the Northern District of California. Several anonymous “John Does” also moved to intervene in the summons enforcement action. However, this was an uphill battle for Coinbase, as the judiciary has routinely acknowledged the broad authority of the IRS under these statutes.

The district court held that the summons serves the legitimate purpose of investigating the reporting gap between the number of Coinbase customers during the period in question and the number of taxpayers who reported a Bitcoin gain or loss to the IRS during the period in question. Although Coinbase had over 5.9 million users during each of the relevant years, only approximately 800 to 900 taxpayers reported Bitcoin property transactions during such period.

The victory for Coinbase came in the form of the court’s narrowed scope of the summons. The court agreed to limit the summons to information relevant to the IRS’s investigation, such as the account holder’s identity and transaction records, and denied the summons's request for other information, such as account-opening records, copies of passports or driver’s licenses, wallet addresses, public keys, records of know-your-customer diligences, etc., which the court held was not relevant. The IRS justified the incredibly broad scope of its summons by arguing “that [it] will not need to return to court to ask for [such information] if and when needed.” The court responded by describing its role as a protector of personal information where such information is not clearly necessary to the IRS's audit. However, the court did acknowledge that the IRS had the authority to proceed with a direct summons to an account holder or to Coinbase if it later determined that it needed more detailed records.

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