COLLECTION OF CRYPTOCURRENCY CUSTOMER-INFORMATION: TAX ENFORCEMENT MECHANISM OR INVASION OF PRIVACY?

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ABSTRACT

After granting permission to the Internal Revenue Service to serve a digital exchange company a summons for user information, the Federal District Court for the Northern District of California created some uncertainty regarding the privacy of cryptocurrencies. The IRS views this information gathering as necessary for monitoring compliance with Notice 2014-21, which classifies cryptocurrencies as property for tax purposes. Cryptocurrency users, however, view the attempt for information as an infringement on their privacy rights and are seeking legal protection.

This Issue Brief investigates the future tax implications of Notice 2014-21 and considers possible routes the cryptocurrency market can take to avoid the burden of capital gains taxes. Further, this Issue Brief attempts to uncover the validity of the privacy claims made against the customer information summons and will recommend alternative actions for the IRS to take regardless of whether it succeeds in obtaining the information.

INTRODUCTION

On November 30, 2016, the Internal Revenue Service (IRS or "the Service") received permission to summon Coinbase, a digital asset exchange company, for user information.[1] The Internal Revenue Code can authorize this broad request, known as a "John Doe Summons," in situations where an ascertainable group can be identified, but the IRS is not practically able to determine the identity of individuals to summon.[2] While

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1 *See* In re Tax Liabs. of Doe, No. 3:16-cv-06658-JSC, 2016 U.S. Dist. LEXIS 184200, at *1–2 (N.D. Cal. Nov. 30, 2016).

2 *See* IRM 25.5.7.2 (2016).

the IRS has repeatedly argued that this information is necessary to monitor the proper tax treatment of cryptocurrencies,[3] Coinbase customers have attempted to block the Summons for invading their privacy rights.[4] Consequently, the IRS Notice 2014-21 regarding the taxation of cryptocurrencies remains effectively unenforceable. Thus, the IRS should take alternative measures to promote tax compliance with Notice 2014-21 and to address both the possibility of the John Doe Summons being overturned by the Court and the certainty of Coinbase's customer information being unreachable for the immediate future.

This Issue Brief proceeds as follows. Part I explores the history of cryptocurrencies and the way they are used today. This section then provides some background on the cryptocurrency exchange system, which should help reveal the issues surrounding the Coinbase Summons for customer-information. Part II then explains the specifics of IRS Notice 2014-21 and discusses competing views regarding the IRS's decision to tax cryptocurrencies as "property." In Part III, this Issue Brief analyzes the impact that Notice 2014-21 has on taxpayers and considers future impacts once the IRS addresses the uncertainties underlying the Notice. Following the discussion of the impact on current and future taxpayers, Part IV introduces the IRS "John Doe Summons" to Coinbase for customer information. This section goes on to present theories for what the IRS is trying to accomplish with this Summons and compares the Coinbase Summons to the UBS Summons in order to explore arguments for why the Court should revoke the former. Part V presents the privacy issues surrounding the Summons and comments on the validity of the legal arguments presented by Coinbase customers in their efforts to block the Summons. Finally, Part VI argues that the IRS should take alternative actions in response to the Summons being delayed in the court system. This Part concludes by presenting two specific alternatives that may address the compliance issues surrounding Notice 2014-21.

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[3] *See* United States' Memorandum in Support of Ex Parte Petition for Leave to Serve John Doe Summons at 7; In re Tax Liabs. Of Doe, No. 3:16-cv-06658-JSC, 2016 U.S. Dist. LEXIS 184200 (N.D. Cal. Nov. 30, 2016), at *1–2; 2016 WL 7010560, at 1.

[4] *See* Nathan Reiff, *"John Doe" Bitcoin Summons has Coinbase Users Fighting Back*, INVESTOPEDIA (Jan. 1, 2017, 4:11 PM), http://www.investopedia.com/news/john-doe-bitcoin-summons-has-coinbase-users-fighting-back/ (reporting that a motion was filed to have the ruling set aside).

I. CHANGING THE WAY MONEY WORKS: A BRIEF OVERVIEW OF CRYPTOCURRENCIES

A. What is a cryptocurrency?

Bitcoin[5], the most widely used cryptocurrency today, shocked the world in 2009 when it accomplished what some thought could never be done: It created a peer-to-peer currency system that could run efficiently *without* a central entity.[6] Simply speaking, a cryptocurrency is a network of "limited entries in a [decentralized] database no one can change without fulfilling specific conditions."[7] The key is that the network is decentralized, meaning there is no intermediary server keeping record of all the transactions and balances.[8] Instead, each cryptocurrency is made up of a network of peers, each having the complete record of every transaction.[9] But until these peers validate the transaction and confirm them, called "proof-of-work," the transaction is not valid.[10] Once confirmed, however, the transaction is irreversible.[11]

B. How does a cryptocurrency exchange work?

To begin a transaction, the sender uses his own private key, a sequence of letters and numbers known only to him, to sign a message to the recipient.[12] This message then goes through a system called "hashing," whereby the message enters through an algorithm and produces an output of a fixed size (but long enough that it has a nearly infinite number of permutations using letters and numbers) regardless of the input size.[13] But

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[5] Due to its acceptance within the cryptocurrency market, relatively high value, and numerous user resources, I predominantly refer to Bitcoin as the representative of all cryptocurrencies; keep in mind, however, that the information largely pertains to all cryptocurrencies including Ethereum, Dash, Ripple, Litecoin, etc.

[6] Tal Yellin, Dominic Aratari, and Jose Pagliery, *What is Bitcoin?*, CNNMONEY, http://money.cnn.com/infographic/technology/what-is-bitcoin/ (last visited Sept. 29, 2017).

[7] Brad Mills, *What is Cryptocurrency: Everything You Need to Know [Ultimate Guide]*, BLOCKGEEKS, http://blockgeeks.com/guides/what-is-cryptocurrency/ (last visited Sept. 29, 2017) (emphasis omitted).

[8] *Id*.

[9] *Id.*

[10] *Id.*

[11] *Id*.

[12] *How Do Bitcoin Transactions Work?*, COINDESK (Mar. 20, 2015), http://www.coindesk.com/information/how-do-bitcoin-transactions-work/.

[13] *See e.g.*, ARVIND NARAYANAN ET AL., BITCOIN AND CRYPTOCURRENCY TECHNOLOGIES: A COMPREHENSIVE INTRODUCTION 2 (2016); Corin Faife, *Bitcoin Hash Functions Explained*, COINDESK (Feb. 19, 2017, 12:35 AM), http://www.coindesk.com/bitcoin-hash-functions-explained/.

since the input messages are created with various complexities, and even a small change to the input creates a completely different output, the private key cannot be hacked even with the combined computing power of every single computer in existence.[14] Once this output message is sent, a network of nodes uses the known algorithms to confirm that the message was sent from a valid source.[15] The driving forces behind this confirmation process are Bitcoin miners, each of whom operates a node to confirm transactions, adds them to their own database, and waits for a specified number of miners to confirm the transaction before being added to the permanent blockchain.[16]

To incentivize miners to take part in this vital step, each solved block produces a new Bitcoin as a reward to the miner for his work.[17] However, there is a finite supply of Bitcoin set by the creator, which means that miners will only receive this reward as long as there is new Bitcoin available to be created.[18] At the current rate of creation, Bitcoin will be exhausted in the year 2140.[19]

C. Cryptocurrency advantages

So what exactly can Bitcoin do that other currencies cannot? As previously mentioned, the most significant aspect of cryptocurrencies is that they are decentralized. This means that transfers can be made on a global level in a matter of minutes, rather than days or weeks.[20] Take, for example, a normal currency transaction between an entity in Zimbabwe and an entity in Turkmenistan. Since banks in Zimbabwe do not have any Turkmenistan manat on hand, and banks in Turkmenistan do not have Zimbabwean dollars on hand, this exchange has to be transferred through a chain of banks with common currencies until the recipient's form of currency can be delivered to them.[21] Since each bank in this chain must approve the currency swap,

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[14] *See* Connor Patterson, *Will Quantum Computing Destroy Bitcoin?*, SMITH & CROWN (May 20, 2016, 1:22 PM), https://www.smithandcrown.com/8655/.
[15] Mills, *supra* note 7.
[16] *Id*.
[17] Melvin Draupnir, *What is the Bitcoin Mining Block Reward?*, BITCOINMINING.COM (May 6, 2016), https://www.bitcoinmining.com/what-is-the-bitcoin-block-reward/.
[18] *See* Anthony Volastro, *CNBC Explains: How to Mine Bitcoins on Your Own*, CNBC (Jan. 24, 2014, 8:57 AM), http://www.cnbc.com/2014/01/23/cnbc-explains-how-to-mine-bitcoins-on-your-own.html (stating that the founders of Bitcoin "set a finite limit on the number of bitcoins that will ever exist: 21 million").
[19] *Id*.
[20] *See* Ian Darrow, Gen. Counsel and Chief Compliance Officer of LedgerX, Presentation to Duke Law School Contract Drafting Class: Smart Contracts and Blockchain Technologies (Feb. 28, 2017).
[21] *See id*.

the entire transaction can take many days, or even weeks, depending on the availability of the currencies involved and the sophistication of the banks.[22] However, the decentralized nature of Bitcoin allows for a global transaction to be approved and executed in the amount of time it takes miners to confirm the transaction and add it to the blockchain, typically about ten minutes.[23]

Additionally, the pseudonymous property of Bitcoin produces distinct advantages to cryptocurrencies over traditional currencies.[24] Since transactions are identified by digital Bitcoin wallet addresses, but are not connected to any real world identity, Bitcoin provides users with a way to conduct exchanges where the traceability does not reach to the individual.[25] While this may be advantageous to some, the pseudonymous nature has created a mess for the IRS as they monitor and enforce the proper tax treatment of cryptocurrency transactions.[26]

II. CRYPTOCURRENCY TAX GUIDANCE: IRS NOTICE 2014-21

A. What does the IRS say?

For the first five years of Bitcoin's existence, there was little guidance or regulation regarding the tax treatment of cryptocurrencies.[27] In the first quarter of 2014, however, the IRS issued Notice 2014-21 describing the treatment of cryptocurrency transactions for tax purposes.[28] Most importantly, this notice revealed that "for federal tax purposes, virtual currency is treated as property [and] [g]eneral tax principles applicable to property transactions apply to transactions using virtual currency."[29] Practically speaking, the application of these principles has four major impacts on cryptocurrency users: First, "wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding

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[22] *See id*.
[23] Sandeep Goenka, *What is all the Fuss About Blockchain*, ENTREPRENEUR INDIA (Mar. 11, 2016), https://www.entrepreneur.com/article/272317.
[24] *See* Mills, *supra* note 7.
[25] *See id.* (noting that the pseudonymous property of Bitcoin makes it "not necessarily possible to connect the real world identity of users").
[26] Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38, 40 (2013) ("Until recently, the Internal Revenue Service ('IRS') has had little success in taxing concealed offshore income.").
[27] *See* Matthew Kien-Meng Ly, *Coining Bitcoin's "Legal Bits": Examining the Regulatory Framework for Bitcoin and Virtual Currencies*, 27 HARV. J. L. & TECH. 587, 600–06 (2014) (indicating many virtual currency lawsuits prior to 2014, but no guidance issued by the IRS).
[28] *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938–40 (2014).
[29] *Id.* at 938.

and payroll taxes."[30] Second, independent contractors who receive Bitcoin for their services provided must treat the receipt as taxable self-employment income, and payers of the Bitcoin must issue a Form 1099.[31] Third, a gain or loss on the transaction (based on the change in value of the cryptocurrency from the time acquired to the time disposed of) must be recognized and its character depends on whether the currency is a capital asset.[32] Fourth, payments made using Bitcoin are subject to the same information reporting requirements as payments made using property.[33]

B. Does treating cryptocurrencies as property make practical sense?

There are competing views regarding the IRS's decision to tax Bitcoin as property. Proponents in support of the IRS's position argue that, since a sovereign government does not issue cryptocurrencies, they do not have the same features as typical currencies and therefore should not be taxed as a currency.[34] Daniel Winters, a Bitcoin tax consultant for Global Tax Accountants, LLC, elaborates on this point by arguing that without a system (i.e. a government) backing the financial instrument, the properties of a traditional currency that act as the rationale for avoiding taxation as property are non-existent.[35]

Those in opposition of the IRS's position use a substance-over form argument. When viewing Bitcoin as a means to purchase goods or services, advocates against Bitcoin being treated as property argue that other currencies fluctuate in the same way that Bitcoin does. Yet, a holder a Euro, for example, does not have to pay taxes on the increased purchasing power he obtains in the United States if the Euro increases in value relative to USD.[36] So, as the argument goes, Bitcoin users should not be subject to a tax for using a means of currency with an arguably equal level of liquidity as any traditional currency produced by a government.[37]

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[30] *IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply*, I.R.S. (Mar. 25, 2014), https://www.irs.gov/newsroom/irs-virtual-currency-guidance.
[31] *Id*.
[32] *Id*.
[33] *Id*.
[34] *See Is The IRS Justified In Demanding Information On Millions Of Bitcoin Users?*, *Unchained: Big Ideas From The Worlds Of Blockchain And Cryptocurrency* (Jan. 24, 2017), https://itunes.apple.com/us/podcast/unchained-big-ideas-from-worlds/id1123922160?mt=2 (downloaded using iTunes).
[35] *See id*.
[36] *See* Adam Chodorow, *How Do You Tax Bitcoin?*, MONEYBOX (Jan. 11, 2016, 11:26 AM), http://www.slate.com/articles/business/moneybox/2016/01/bitcoin_s_future_depends_on_what_the_world_s_tax_authorities_rule.html.
[37] *See generally id.*

C. Concerns with treating cryptocurrencies as property

There are many logistical concerns associated with IRS Notice 2014-21. To begin, the Notice leaves taxpayers wondering how they are supposed to maintain sufficient records to calculate the tax due.[38] Especially for users who conduct numerous transactions a day, as well as for those that consistently use Bitcoin as a method of payment for everyday consumption, keeping track of the basis for every Bitcoin is unduly burdensome and arguably impossible.[39] Think about a consumer needing to keep track of the change in exchange rate from the date he acquired a particular dollar until the time he spent it, every time he bought a cup of coffee.[40] Without a central exchange to electronically record this information and match a specific identity to the transaction, this method of taxation is infeasible. Further, uncertainty surrounds the accounting method for determining basis of the exchanged Bitcoin.[41] Should the individual use FIFO?[42] LIFO?[43] Or some other method?[44] Ultimately, while the IRS's goals in taxing cryptocurrencies as property are not inherently wrong, the IRS has yet to think of a process to tax cryptocurrencies effectively and therefore should not attempt to place an unrealistic burden upon the taxpayer.

III. A DEEPER LOOK AT THE EFFECT NOTICE 2014-21 WILL HAVE ON THE FUTURE OF CRYPTOCURRENCY TAXATION

A. IRS reporting

1. Valuation

There is a significant level of uncertainly towards the route the IRS will take with respect to the valuation of Bitcoin for tax purposes for two reasons. First, Bitcoin's price constantly fluctuates.[45] Second, there are

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[38] Josh Ungerman, *IRS Approach To Taxation of Bitcoin*, FORBES: IRS WATCH (Dec. 4, 2014, 1:02 AM), http://www.forbes.com/sites/irswatch/2014/12/04/irs-approach-to-taxation-of-bitcoin/.
[39] *See id*.
[40] *See generally id*.
[41] *See id*.
[42] *See id*. FIFO stands for "First in, First Out" and values the exchanged Bitcoin based on the value of the oldest Bitcoin that came into the transferor's wallet.
[43] *See id*. LIFO stands for "Last in, First Out" and values the exchanged Bitcoin based on the value of the most recent Bitcoin in the transferor's wallet.
[44] *See id*.
[45] *See* Allison Kroeker, *Virtual Currency Transactions and Bitcoin Investment Issues Under U.S. Tax Law*, ROYSE LAW FIRM (Aug. 27, 2017, 5:49 PM), http://rroyselaw.com/tax-law/cryptocurrency/virtual-currency-transactions-and-bitcoin-investment-issues-under-us-tax-law/.

various taxable events related to Bitcoin, each with arguably different valuation methods.[46]

Price volatility creates a very real issue for valuation purposes because it can be the difference between a taxable gain and a taxable loss if the price changed dramatically in the day you originally received the Bitcoin.[47] For example, in a three-month span during late 2013 and early 2014, Bitcoin's value fell from $1,117 to around $550.[48] Since monitoring a Bitcoin's purchase date is difficult, and because the currency is extremely volatile, the IRS will probably establish a detailed valuation formula to determine taxable gains and losses related to cryptocurrencies. Perhaps the IRS could value Bitcoin using a 3-month floating average of Gross World Product (GWP).[49] Valuing Bitcoin this way would allow for larger margin of error regarding the date Bitcoin was purchased and sold by individual users.

Additionally, three different taxable events occur in the lifecycle of a Bitcoin transaction, which make valuing it difficult.[50] Since Bitcoin transactions can take the form of either receipt from mining, sale of investment, or use as currency, the IRS must distinguish between the three in the future.[51] While the sale as investment and use as currency activities have similar tax treatment in the form of a gain or loss, receipt of Bitcoin from mining should arguably be treated as ordinary income for performance of services under §83 of the Internal Revenue Code.[52] This can make valuation difficult if the source of the Bitcoin is unable to be determined.[53] For these reasons, the IRS will likely issue revenue rulings in the future that specifically differentiate between the sources of the Bitcoin and require a

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[46] *See id*.

[47] *See* Stephen Fishman, *IRS'[s] Bitcoin Guidance Turns Every Transaction Into a Reportable Capital Gain or Loss at Tax Time*, INMAN (Mar. 31, 2014), http://www.inman.com/2014/03/31/irss-bitcoin-guidance-turns-every-transaction-into-a-reportable-capital-gain-or-loss-at-tax-time/.

[48] *See* Adam Yoran, *Is It Really Here to Stay? What the Mt. Gox Bankruptcy Means for Bitcoin*, COLUM. BUS. L. REV. (Mar. 5, 2014, 12:57 PM), https://cblr.columbia.edu/is-it-really-here-to-stay-what-the-mt-gox-bankruptcy-means-for-bitcoin/.

[49] In order for this valuation method to be viable, research would have to confirm a strong, positive correlation between the trading price of Bitcoin and GWP, which is a measure of the strength of the World's economy.

[50] *See* Fishman, *supra* note 47.

[51] *See id*.

[52] I.R.C. § 83 (2004).

[53] *See generally* Fishman, *supra* note 47. While both income from services and prize income are treated as taxable income, the characterization is important. For example, since expenses incurred to obtain a prize can arguably be netted against prize income, the characterization has tax implications.

Form 1099 to be furnished upon any receipt of Bitcoin for services provided.

2. Capital vs. non-capital asset

The IRS must issue some guidance on whether Bitcoin is treated as a capital asset or a non-capital asset.[54] This question is muddled with confusion because the Internal Revenue Code currently defines eight specific types of assets that are *not* capital assets, but does not affirmatively specify what *is* a capital asset.[55] Even assuming that the IRS intends all assets (other than the eight listed exceptions) to be classified as "capital," the question remains whether Bitcoin is considered a "financial instrument," which falls under one of the eight exceptions. Bitcoin's classification is very important because capital gains rates are currently much lower for most taxpayers than ordinary income rates are.[56] To some extent, Notice 2014-21 addresses this issue in FAQ 9 by specifically noting that Bitcoin miners must include in gross income the resulting Bitcoin they obtain from their activities.[57] However, the underlying question is still up for some debate. The ABA's Section of Taxation chairman suggested the possibility that mined Bitcoin could be treated as prize income, earned income, or even capital assets, depending on the particular instances and asked the Commissioner of the IRS for additional guidance.[58] Regardless, one thing is certain: The rules do not clearly address a significant number of issues regarding the taxation of cryptocurrencies and future guidance is necessary as cryptocurrencies continue to evolve.

3. Penalties for failure to comply

Although the taxation of cryptocurrencies is largely "new and uncharted waters," the IRS has nonetheless announced that it may

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[54] Christopher Rajotte, Andrew Ittleman & Mitchell Fuerst, *Bitcoin Taxation: Understanding IRS Notice 2014-21*, BITCOIN MAGAZINE (Apr. 4, 2014, 9:20 PM), https://bitcoinmagazine.com/articles/bitcoin-tax-understanding-irs-notice-2014-21-1396660800/.

[55] I.R.C. § 1221 (2010) (excluding the following from the definition of a capital asset: inventory, real or depreciable property held for use in the taxpayer's trade or business, intellectual property created through the taxpayer's personal efforts, accounts receivable, government documents, certain dealer-held derivative financial instruments, hedging transactions, and non-inventory supplies regularly used or consumed by the taxpayer in his trade or business).

[56] *See* Rajotte, Ittleman & Fuerst, *supra* note 54.

[57] *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 939 (2014).

[58] *See* Letter from Armando Gomez, Chair, Sect. on Tax., Am. Bar Assoc., to John Koskinen, Comm'r, Internal Revenue Serv. (Mar. 24, 2015) (posing the question "[C]an [B]itcoins acquired by solving the algorithm be treated as a capital gain where a miner has invested in the activity, but has not been actively involved in the enterprise?").

implement penalties for failure to comply, including for transactions that occurred during and prior to 2013.[59] This retroactive effect further compounds the recording problem discussed above, because taxpayers may not have receipts from every time they make a purchase with Bitcoin. Nor do taxpayers have record of every Bitcoin sale for investment like they would if they were selling stock through an exchange.[60]

B. Outside disclosure

Now that the IRS has issued Notice 2014-21, taxpayers and tax specialists will question whether outside disclosure applies as well. Specifically, Notice 2014-21 is silent regarding the Bank Secrecy Act, which has significant applications to Bitcoin transactions.[61] Under the Foreign Bank Account Report Obligation (FBAR) of the Bank Secrecy Act, each U.S. citizen with an interest in a financial account in a foreign country must file an account record with the department of Treasury if the combined value of such exceeds $10,000 at any point within the year.[62] Without any additional information from the IRS on this subject, it is uncertain whether a U.S. person who owns more than $10,000 of Bitcoin that is preserved on a computer server located outside the United States is subject to these FBAR filing requirements.[63] Perhaps an even more intriguing question, does the extremely volatile nature of Bitcoin support a policy justification to exclude Bitcoin from FBAR requirements or increase the triggering-point?

C. Increased and more complex rules

While the IRS intended to clarify the Code by issuing Notice 2014-21, it raised many new questions. For example, the simple determination that cryptocurrencies are to be taxed as property rather than as currency created the issue of whether virtual currencies are passive assets for purposes of the fifty percent asset test for passive foreign investments.[64] Further, it created uncertainty regarding like-kind exchange treatment, the applicability of the elective mark-to-market rules of § 465 and § 1256, charitable contributions, foreign tax credit, and barter transactions.[65] While this is nowhere near an exhaustive list, it reveals the metaphorical can of worms the IRS has opened by issuing Notice 2014-21. If the IRS continues to treat cryptocurrencies as property, cryptocurrency users who think the Code does not address their situation will fuel the next decade with

[59] *Id*.
[60] *See generally id*.
[61] *See* Rajotte, Ittleman & Fuerst, *supra* note 54.
[62] *See* 31 U.S.C. § 5314(a) (2012).
[63] *See* Rajotte, Ittleman & Fuerst, *supra* note 54.
[64] *See id*.
[65] *See id*.

challenges to the IRS. In turn, we may see the tax code be amended to a point where it is even more complicated than it is today. While it is helpful to narrow down certain areas where more guidance from the IRS is needed,[66] the future of the United States tax system will likely be inundated with uncertainty as cryptocurrencies and affiliated issues continue to advance.

IV. IRS's Solution: "John Doe Summons" to Coinbase for Customer Information

In late 2016, upon realizing that it was unable to enforce and monitor compliance with Notice 2014-21 due to Bitcoin's pseudonymous nature, the IRS requested that the Northern District of California authorize a John Doe Summons[67] requiring Coinbase to deliver customer information to the IRS.[68] On November 30, 2016, the court granted the Summons and the IRS received the authority to serve Coinbase for the identity of all U.S. taxpayers who conducted a transaction through Coinbase during 2013, 2014, and 2015.[69] While Coinbase and its users were irate about the request,[70] the IRS offered four main arguments in support of the necessity of this action. First, the IRS claimed that because virtual currency transactions are "subject to fewer third-party reporting requirements than conventional forms of payment," tax underreporting on cryptocurrencies occurs at a higher rate than traditional payments.[71] Second, the "relatively high degree of anonymity associated with virtual currency transactions" makes the IRS unable to tell if, and to what extent, cryptocurrencies are being

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[66] *See id*.

[67] I.R.C. § 7609 (c)(3), (f) (2016) (defining a John Doe Summons as "a summons that does not identify the person with respect to whose liability the summons is issued").

[68] United States' Memorandum in Support of Ex Parte Petition for Leave to Serve John Doe Summons at 7, In re Tax Liabs. Of Doe, No. 3:16-cv-06658-JSC, 2016 U.S. Dist. LEXIS 184200 (N.D. Cal. Nov. 30, 2016) at *1–2; 2016 WL 7010560, at 1. Interestingly, Coinbase is doing everything within its power to comply with regulations. For example, Coinbase follows the requirements set forth in the Patriot Act, provides users with tools for identifying their basis in their Bitcoin for tax purposes, and provides 1099-K forms in limited circumstances. *See Is Coinbase Regulated*, COINBASE (Dec. 21, 2016), https://support.coinbase.com/customer/en/portal/articles/2689172-is-coinbase-regulated-.

[69] *See* Press Release, U.S. Dep't of Justice, Court Authorizes Service of John Doe Summons Seeking the Identities of U.S. Taxpayers Who Have Used Virtual Currency (Nov. 30, 2016) (on file with author).

[70] *See* Reiff, *supra* note 4.

[71] United States' Memorandum in Support of Ex Parte Petition for Leave to Serve John Doe Summons at 7, In re Tax Liabs. Of Doe, No. 3:16-cv-06658-JSC, 2016 U.S. Dist. LEXIS 184200 (N.D. Cal. Nov. 30, 2016) at *1–2; 2016 WL 7010560, at 1.

underreported.[72] Third, there is a "public perception that virtual currency can be used to evade taxes, including at least one instance of open acknowledgement by [B]itcoin users that tax evasion is a sought-after feature of using [B]itcoin[]."[73] Fourth, the IRS argued that because there are many different approaches regarding the valuation of a Bitcoin, the IRS needed the details of each virtual currency transaction to ensure that taxpayers were properly implementing the valuation guidance in Notice 2014-21.[74]

While the IRS made some valid points, cryptocurrency lawyers and tax accountants generally perceive that this Summons is a fishing expedition and that the IRS's claims about Bitcoin being used to evade taxes are unfounded.[75] Tax accountant Daniel Winters believes that the John Doe Summons request indicates that the IRS has "a fundamental misunderstanding of bitcoin and blockchain technology" and by seeking such a broad summons for an exchange that works with more than 45,000 merchants indicates that the IRS's "only focus is that Bitcoin can be used for tax evasion and money laundering."[76] Further, when comparing the Coinbase Summons to previous John Doe summonses, it becomes even more evident that the IRS's actions are unjustified.[77] Here, the IRS has evidence of a mere three entities (only one being an individual) breaking the law by using cryptocurrencies on Coinbase.[78] Additionally, its evidence against Coinbase for the two non-individuals is limited to the simple fact that the fraudulent parties happened to hold Coinbase accounts.[79] However, compared to the 2015 John Doe Summons that compelled Swiss global financial services company, UBS AG, to provide the identity of U.S. taxpayers holding accounts with the Swiss bank Wegelin & Co., here the IRS has much less evidence of criminal activity occurring via Coinbase.[80] With UBS AG, the IRS knew of $1.2 billion dollars being hidden in Swiss bank accounts before deciding to request the John Doe Summons.[81] In light

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[72] *Id*.
[73] *Id.* (citing Eleazar Melendez, *Bitcoin Celebrated as a Way to Avoid Taxes*, THE HUFFINGTON POST (Apr. 16, 2013, 1:33 PM), http://www.huffingtonpost.com/2013/04/16/bitcoin-taxes_n_3093182.html.
[74] *See id*.
[75] *See generally Is The IRS Justified In Demanding Information On Millions Of Bitcoin Users?*, *supra* note 34.
[76] *Id*.
[77] *See id*.
[78] *See id*.
[79] *See id.*
[80] *See* Press Release, U.S. Dep't of Justice S.D.N.Y., Court Authorizes IRS To Seek Records From UBS Relating To U.S Taxpayers With Swiss Bank Accounts (Jan. 28, 2013) (on file with author).
[81] *See id*.

of these facts, Winters believes the Coinbase Summons is unjustified because unlike the "evidence of criminal activity on a broad scale" at UBS AG, the evidence and rationale for the Coinbase Summons is "three users broke the law, and therefore we're now going to treat the other 99.99% of users as criminals."[82]

V. IS THE IRS ACTING WITHIN ITS AUTHORITY?: EXAMINING THE IRS'S POWER VS. A RIGHT TO PRIVACY

A. IRS's authority

Arguably the most basic function of the IRS is to review and audit tax returns filed in the United States and make sure that taxpayers pay the correct amount of taxes due.[83] Specifically, § 7601 of the Internal Revenue Code requires the Secretary of the Treasury to "cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax."[84] This general authority for the IRS to summon the possessor of information relating to the accuracy of a taxpayer's return is specifically addressed in case law.[85] For example, the Court has granted the IRS the authority to issue John Doe summonses to banks or other depositories to discover the identity of individuals who may have failed to disclose all of their income.[86] Additionally, the Court has determined that this authority does not require that the Government "make a showing of probable cause to suspect fraud."[87] To protect taxpayers, this power is balanced by a requirement that only the court can enforce these summonses.[88] Further, § 7609(f) of the Internal Revenue Code limits this right to situations where there is an "ascertainable class" being investigated.[89] An "ascertainable class" has been

[82] *See Is The IRS Justified In Demanding Information On Millions Of Bitcoin Users?, supra* note 34.
[83] United States' Memorandum in Support of Ex Parte Petition for Leave to Serve John Doe Summons at 7, In re Tax Liabs. Of Doe, No. 3:16-cv-06658-JSC, 2016 U.S. Dist. LEXIS 184200 (N.D. Cal. Nov. 30, 2016) at *1–2; 2016 WL 7010560, at 1.
[84] I.R.C. § 7601 (2016). § 7602 expressly provides the IRS the authority to summon information to achieve these purposes. *See* I.R.C. § 7602 (2012).
[85] *See, e.g.*, United States. v. Bisceglia, 520 U.S. 141 (1975); United States v. Powell, 379 U.S. 48 (1964).
[86] *Bisceglia*, 520 U.S. at 150.
[87] *Powell*, 379 U.S. at 51.
[88] *See* Reisman v. Caplin, 375 U.S. 440 (1964).
[89] I.R.C. § 7609(f) (2016).

found to include a group of people holding any financial interest managed or held by a financial institution.[90]

B. Customers' right to privacy

While all legal precedent establishing the IRS's authority has yet to be applied to the realm of virtual currencies, Coinbase customers have a right to privacy that supports Jeff Berns' motion to have the Summons ruling set aside.[91] Most importantly, the Right to Financial Privacy Act of 1978 provides that:

> "no Government authority may have access to or obtain copies of, or the information contained in the financial records of any customer from a financial institution unless the financial records are reasonably described and-- (1) such customer has authorized such disclosure in accordance with section 1104."[92]

If Coinbase is characterized as a "currency exchange," it meets the definition of a "financial institution"[93] and the Right to Financial Privacy Act appears to apply. Consequently, the Summons for Coinbase information should be halted.

The strongest support from case law comes from California Bankers Ass'n v. Shultz.[94] In Shultz, the Court determined that "(b)anks are . . . not . . . neutrals in transactions involving negotiable instruments, but parties to the instruments with a substantial stake in their continued availability and acceptance."[95] Since this case played a strong role in Congress's adoption of the RFPA, it indicates some intention to maintain privacy for information in the possession of "parties to the instruments with a substantial stake in their continued availability and acceptance."[96] Coinbase, as "a secure online platform for buying, selling, transferring, and

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[90] Order Granting Ex Parte Petition for Leave to Serve "John Doe" Summons, Docket No. 10, Case No. 11-CV-1686 (LB) (N.D. Cal. Apr. 7, 2011) (finding that an "ascertainable class" includes "interests in or signature or other authority [including authority to withdraw funds; trade or give instructions or receive account statements, confirmations, or other information, advice or solicitations] with respect to any financial accounts maintained at, monitored by, or managed through The Hongkong and Shanghai Banking Corporation").

[91] *See* Reiff, *supra* note 4.

[92] Right to Financial Privacy Act of 1978 § 1102, 12 U.S.C. § 3402.

[93] 31 U.S.C. § 5312(a)(2)(J) (denoting that a "currency exchange" meets the definition of a "financial institution" under the Right to Financial Privacy Act).

[94] *See* 416 U.S. 21 (1974).

[95] *Id.* at 48–49.

[96] *See generally The Right to Financial Privacy Act*, ELECTRONIC PRIVACY INFORMATION CENTER, https://epic.org/privacy/rfpa/ (last visited Mar 3, 2017).

storing digital currency,"[97] arguably has a substantial stake in the continued availability and acceptance of cryptocurrencies, which can be negatively impacted if the IRS can access Coinbase's customer information.[98] Therefore, the RFPA's intent should be found to protect cryptocurrency exchanges, including Coinbase.

VI. ALTERNATIVE ACTIONS THE IRS SHOULD TAKE REGARDLESS OF SUMMONS OUTCOME

The IRS should take alternative action regardless of whether the Coinbase customers are successful in their attempts to block the Summons because the Service has an incentive to promote cryptocurrency reporting as soon as possible. Even if the motion is denied and the IRS is able to obtain customer information, the delay that will occur as a result of the Summons being held up in the court system will have a significant impact on the 2016 tax returns filed by cryptocurrency users.[99] Irrespective of the Summons for Coinbase's customer information, there are two specific actions the IRS can take to promote tax reporting by cryptocurrency users.[100] First, the IRS could create a de minimis exception.[101] A de minimis exception would reduce the reporting burden of day-to-day use of cryptocurrencies to purchase goods, which would allow the IRS to focus more on the larger transactions.[102] More importantly, a de minimis exception would reduce the pushback against Notice 2014-21 by users, which may help to create an acceptance of cryptocurrency transactions as a taxable event.[103] Second, the IRS could repeal Notice 2014-21 and instead classify Bitcoin as a currency, in turn triggering a requirement that the exchanges issue 1099 forms to customers.[104] While this would lower the overall marginal tax rate on cryptocurrency users (and eliminate it entirely for those using Bitcoin to purchase goods), it would allow the IRS to ensure a greater reporting

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[97] *What is Coinbase?*, COINBASE (Feb. 23, 2017), https://support.coinbase.com/customer/en/portal/articles/585625-what-is-coinbase-.

[98] *See generally* Daniel Winters, *What the IRS Summons Will Mean for Coinbase Users*, COINDESK (Dec. 3, 2016, 4:54 PM), http://www.coindesk.com/irs-summons-will-mean-coinbase-users/.

[99] *See* JP Buntinx, *Coinbase Hearing In IRS Summons Case Delayed Until March 23*, NEWSBTC (Feb. 4, 2017, 11:00 PM), http://www.newsbtc.com/2017/02/04/coinbase-hearing-irs-summons-case-delayed-march-23/.

[100] *See generally Is The IRS Justified In Demanding Information On Millions Of Bitcoin Users?*, *supra* note 34.

[101] *See id*.

[102] *Id*.

[103] *Id*.

[104] *Id*.

percentage.[105] By increasing the reporting percentage, monitoring costs would decrease and gross tax payments to the IRS with respect to cryptocurrencies may even increase if the current compliance rate really is as low as the IRS claims.

CONCLUSION

Some argue that the IRS significantly changed the tax landscape when it issued Notice 2014-21.[106] However, the tax landscape changed the moment cryptocurrencies came into existence. Cryptocurrencies changed the way in which transactions are conducted and income is generated. Hence, taxation on virtual currency was inevitable. The only question left was, "how will it be done?" While Coinbase customers and cryptocurrency users alike balked at the IRS's attempt to answer this question by filing for a summons,[107] the Service was arguably doing the job given to it by the federal government.[108] Whether the IRS overstepped its authority by issuing the Summons is debatable, but the purpose and intent surrounding the creation of RFPA indicates that the IRS's actions were unjustified.[109] With this in mind, as Coinbase customers continue to argue against the Summons and seek to delay the obligatory release of their identities and virtual currency transaction, the IRS should be proactive and take steps to promote voluntary compliance with the Notice. The extent of any action, or inaction, by the IRS in the coming months remains to be seen, and only time will tell whether it responds wisely.

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[105] *Business 1099 Requirements,* NAT'L FED'N OF INDEP. BUS., http://www.nfib.com/cribsheets/1099-requirements/ (last visited Mar. 3, 2017).
[106] *See generally* Interview by Michael Scott with Daniel Winters, Tax Professional, Global Tax Accountants (Nov. 21, 2016).
[107] United States' Memorandum in Support of Ex Parte Petition for Leave to Serve John Doe Summons at 7, In re Tax Liabs. Of Doe, No. 3:16-cv-06658-JSC, 2016 U.S. Dist. LEXIS 184200 (N.D. Cal. Nov. 30, 2016) at *1–2; 2016 WL 7010560, at 1.
[108] I.R.C. § 7601 (2016).
[109] *Compare* Right to Financial Privacy Act of 1978 § 1102, 12 U.S.C. § 3402 *with* California Bankers Assn. v. Shultz, 416 U.S. 21, 48–49, 94 (1974).