


# DOJ Seeks John Doe Summons on Largest U.S. Bitcoin Exchanger


By

[Andrew Velarde](#)

[Contact Author](#)

In an effort to combat tax evasion, the Justice Department petitioned a district court November 17 to serve a John Doe summons on bitcoin exchanger Coinbase Inc., seeking records and account holder identities.

"Due to [the] anonymity and lack of third-party reporting, the IRS is concerned that U.S. taxpayers are underreporting taxable income from transactions in virtual currencies," states the DOJ's memorandum  in support of ex parte petition for leave to serve a John Doe summons. "Further, because the IRS considers virtual currencies to be property, United States taxpayers can realize a taxable gain from buying, selling, or trading in virtual currencies. There is a likelihood that United States taxpayers are failing to properly determine and report any taxable gain from such transactions."

The DOJ filed its petition  in the U.S. District Court for the Northern District of California. The memorandum is accompanied by a declaration of support by David Utzke, senior revenue agent with the IRS's offshore compliance initiatives program.

"Because there is no third-party reporting of virtual currency transactions for tax purposes, the risk/reward ratio for a taxpayer in the virtual currency environment is extremely low, and the likelihood of underreporting is significant," Utzke said. The lack of withholding and use of peer-to-peer systems instead of traditional financial intermediaries further enables virtual currencies to "replace traditional abusive tax arrangements as the preferred method for tax evaders."


The value of bitcoin transactions exceeded \$10 billion in 2015, according to Utzke, who supported his declaration based on previous taxpayer interviews. According to Utzke, one taxpayer had become "fatigued" with the effort required in using his traditional abusive offshore arrangement and abandoned it in favor of virtual currency to avoid detection on repatriation of assets. Also, Utzke's exams of two other corporate entities that had accounts at Coinbase resulted in admissions of disguising amounts spent to purchase bitcoin as tax-deductible technology expenses.


Public perception could also play a role in using bitcoin to evade taxes, according to Utzke. He noted that a basic Google search for "avoid taxes with bitcoin" resulted in approximately 436,000 hits.

The DOJ may have to gear up for a fight with Coinbase, which has 4.8 million customers in 32 countries and \$5 billion exchanged, making it the largest bitcoin exchanger in the United States as of December 2015. According to a November 18 company blog post, Coinbase will oppose

the current form of the petition in court, out of concern for its customers' privacy.

"The government has not alleged any wrongdoing on the part of Coinbase and its petition is predicated on sweeping statements that taxpayers may use virtual currency to evade taxes," the blog states. "Although Coinbase's general practice is to cooperate with properly targeted law enforcement inquiries, we are extremely concerned with the indiscriminate breadth of the government's request."


The summons seeks to identify U.S. persons who have not properly reported income from the use of the virtual currency and defines the class as persons who conducted transactions in a convertible virtual currency, as defined in Notice 2014-21, 2014-16 IRB 938 , between 2013 and 2015. It seeks know-your-customer due diligence performed on those accounts, associated transaction records, account statements, and records of payments.


In Notice 2014-21 the IRS states that convertible virtual currency for federal tax purposes is treated as property and that general tax principles regarding property transactions apply to virtual currency. That means that the taxpayer may claim capital gains or losses on the exchanges of the currency depending on whether the virtual currency is a capital asset in the hands of the taxpayer. (Prior coverage )



According to the notice, "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 the virtual currency was received." A person who makes a payment using virtual currency is subject to the information reporting requirements for payments made in property.

Taxpayers may be subject to accuracy-related penalties under [section 6662](#) and information reporting penalties under [sections 6721](#) and [6722](#).

### **Additional IRS Actions Needed**

In 2015 an IRS official warned taxpayers that the Criminal Investigation division was looking at virtual currencies not only for their potential in criminal activities, such as money laundering, but also for possible tax evasion and filing of false returns. (Prior coverage )

CI also reported  in December 2015 that it would continue to focus on virtual currency financial crimes in 2016 and "seek to work with private companies and organization, such as Coinbase and the Blockchain Alliance, to stay current on the threats posed by the use of virtual currency."

In a September report , the Treasury Inspector General for Tax Administration said the IRS should develop a strategy for handling virtual currency, update guidance regarding documentation requirements and tax treatment of virtual currency, and rework information reporting forms to identify virtual currencies used. (Prior coverage )

TIGTA found little evidence of a coordinated program to identify and address "potential taxpayer noncompliance issues for transactions involving virtual currency." TIGTA acknowledged that the Large Business and International Division was looking at the feasibility of creating a campaign

around noncompliance related to virtual currency, but added that "this work is still in the discussion stages."


The IRS agreed that additional guidance on documentation requirements and tax treatments for various uses of virtual currencies would be helpful, but noted that guidance decisions are subject to "available resources and other competing organizational and legislative priorities."

TIGTA also suggested that revising third-party information reporting documents would encourage taxpayer compliance and "provide the IRS with some of the data necessary to analyze the risk of taxpayer reporting noncompliance regarding virtual currencies."

### **A Wide Net**

Under [section 7609](#), a John Doe summons may be served if it relates to an investigation of an ascertainable class, there is a reasonable basis to believe that the class has failed to comply with tax law, and the information sought is not readily available from other sources. Scott Michel of Caplin & Drysdale Chtd. offered a word of caution to taxpayers who might be implicated in the summons. "The service of a John Doe summons does not disqualify a taxpayer from making a voluntary disclosure, so anyone who's got a problem here has a short window to take care of it. Once the names are disclosed -- and it's almost certain they will be -- that window will likely close," Michel said.

Shamik Trivedi of Grant Thornton LLP suggested that practitioners "advise their clients who are making payments in virtual currency or being paid in virtual currency to ensure they are compliant with the law, and moreover, that given the nature of how each and every transaction is recorded, that taxing authorities will, eventually, determine who the parties are at each side of each transaction."


Trivedi said the efforts by the DOJ "should not be surprising, given the work IRS CI has already conducted in this area, as well as the reports by the [Government Accountability Office]  and TIGTA on the risk of tax evasion by individuals utilizing virtual currencies."

Josh O. Ungerman of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP argued that the summons was broad and that if granted, it would provide the IRS with a large amount of information. The IRS would then cross-reference that information with tax returns and classify which returns had the most potential for a successful criminal investigation versus those for which proposed civil adjustments were necessary, he said.

"The defense to the John Doe Summons in the Coinbase matter will most likely revolve around the broad definition of the ascertainable class -- every user from 2013 to 2015 -- and the existence or not of a reasonable basis to believe the class of persons failed (or may fail) to comply with the internal revenue laws," Ungerman said, noting that the government cites three instances of noncompliance, two of which include Coinbase. "The likely challenge would be based on producing a vast amount of information based on only two Coinbase instances of noncompliance instead of identifying the specific types of characteristics that lead to the assumption there is noncompliance," he said, citing the tax shelters in the late 1990s and early 2000s when the IRS identified specific characteristics of taxpayers, promoters, and financial institutions that were red flags of noncompliance.

"The mere fact that a taxpayer conducted business with Coinbase is the only characteristic that triggers the production of information to the IRS; there is no additional refining or limiting characteristic that narrows the field of potential candidates for disclosure," Ungerman continued. He added that a transaction dollar threshold could be one way to narrow the request. "The IRS is trying to replicate the success with a John Doe summons to a bartering organization requesting information from the 1970s with virtual currencies and Coinbase. I would not be surprised if the district court judge required more refinement with respect to Coinbase."

While acknowledging that the government has had much success issuing John Doe summonses in the past, Kevin F. Sweeney of Chamberlain, Hrdlicka, White, Williams & Aughtry wondered whether the case may be one "where they push a little too far and they start setting some bad precedent."

Larry A. Campagna of Chamberlain agreed. "I just don't see any qualifying criteria in what they are asking for," he said. "When they hit Wells Fargo with the summons, it was relating to the use of the corresponding accounts from First Caribbean Bank. That seems narrow. . . . That is at least a defined class of people. . . . Here their principle seems to be if you are using virtual currency, you must be doing it for nefarious purposes." He added that in the case of Wells Fargo, the government went out of its way to specify it was not accusing Wells Fargo of wrongdoing, in apparent contrast to the Coinbase case. (Prior coverage )

"There seems like there is one step that is missing," Sweeney said. "The first step is that there are instances at this particular institution. The second is what specific way was it used in order to think there was a problem." He added, "It seems here that the government is making a more general argument that it is inherently susceptible to criminal activity and therefore we get it all. I'm not sure they've done that before."