Practitioners See No Rush to Add Cryptocurrency to Badges of Fraud

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Between possible non-tax-evasion motives for even the most secretive uses of virtual currencies and the long list of open tax questions, practitioners say the IRS shouldn't hurry to amend its badges of fraud list.

The roller-coaster valuations and secrecy promises of cryptocurrencies have drawn the attention of the media, investors, consumers, and IRS investigators. The attention of the latter has most recently taken the form of a Large Business and International Division compliance campaign and part of an international criminal tax enforcement collaboration.

At a July conference, a practitioner asked an IRS Criminal Investigation division special agent in charge whether the IRS is viewing the use of cryptocurrency as its own badge of fraud, similar to how unexplained uses of large amounts of cash are a badge of fraud. The special agent said he hadn't heard of that happening.

Nathan J. Hochman of Morgan, Lewis & Bockius LLP, a former head of the Justice Department's Tax Division and the practitioner who had asked the question, told *Tax Notes* that one major issue with treating cryptocurrency as an independent badge of fraud is the general taxpayer's lack of understanding of the IRS's position that the currencies are property rather than "currency."

While the lack of understanding concerning virtual currency makes it an attractive vehicle for fraud, the government needs to better clarify the tax treatment of cryptocurrencies and educate taxpayers before it considers amending the badges of fraud list, according to Chaya Kundra of Kundra & Associates PC.

"It is too easy to leap to the conclusion that the use of cryptocurrency, in and of itself, is a badge of fraud, and anyone who leaps to that conclusion is not making a valid leap," according to Sanford J. Boxerman of Capes, Sokol, Goodman & Sarachan PC. Practitioners should guard against individual IRS employees and the institution as a whole making that leap, he said.

"It would be a bigger problem if bitcoin or any other virtual currency was large enough that you could live your whole life transacting in nothing but bitcoin," Boxerman said. Bitcoin, the most widely known cryptocurrency, hasn't reached that point yet, so taxpayers still have to interact with fiat currencies such as dollars at some point, and the IRS already has ways to obtain information at those points, he said.

Existing Badges

Hochman said the current list of badges of fraud should be able to address most of the behavior surrounding virtual currencies, and only a few new modes of value transactions could be added.

"Cryptocurrency, by itself, is not illegal, just like cash is not illegal," Hochman said. While unexplained uses of large amounts of currency is one badge of fraud, that badge explicitly allows for a possible reasonable explanation, he said. For example, some businesses just happen to take in lots of cash and those that properly account for it all aren't behaving fraudulently, he added. "In other words, cash can be a badge of fraud if used in certain ways, but it also can be a completely legitimate form of transaction," he said.

Electronic transmission, however, can make cryptocurrencies operate "like cash on steroids" by surpassing the limitations inherent in the physical transfer of coins or bills, Hochman said. Cryptocurrencies can be transferred to the other side of the world in seconds and without the ability to see the other party, he said. The transferor may not even know where in the world the payment was sent, he added.

The list of badges of fraud is in Internal Revenue Manual section 25.1.2.3 and was last updated in 2015. Misuses of cryptocurrencies might be accounted for under such badges as "inadequately explaining dealings in large sums of currency, or the unexplained expenditure of currency," "failing to deposit receipts in a business account, contrary to established practices," "concealment of records," "transaction not in the usual course of business," or "use of secret bank accounts for income."

The IRS's only pronouncement on virtual currency could throw a wrinkle into use of the first badge. In Notice 2014-21, 2014-16 IRB 938, the IRS took the position that cryptocurrencies will be treated as property rather than foreign currency. Because of the limited guidance on the proper tax treatment of cryptocurrencies, practitioners have suggested that the first criminal tax prosecutions involving the new technology will likely depend on old-school bad behaviors.

Boxerman said that while he might not explicitly try to draw the distinction between the use of "currency" in the badges of fraud and the property treatment under Notice 2014-21, "to the extent a revenue agent viewed cryptocurrency, in and of itself, as a badge of fraud or inherently suspicious, I would push back on that pretty strongly." Boxerman said he is concerned that some may make that leap despite an official IRS view to the contrary.

The existing badges of fraud can be applied to cryptocurrencies without making any special changes, Boxerman said.

Kundra compared the emergence of cryptocurrencies to the creation of the passive foreign investment company reporting regime and to foreign bank account reports. When those regimes were introduced, few taxpayers knew what they were until the IRS had achieved a basic level of taxpayer education, she said, adding that the same sort of effort is needed with regard to virtual currencies.

"Only then can we really even begin to peel back the layers of whether or not this is going to be a fraudulent transaction," Kundra said.

Legitimate Secrecy Interests

Tumbling or mixing services — in which an owner submits some currency into a pool with other people's coins, and each participant then gets back a different specific coin — present one possible new cryptocurrency phenomenon that might be destined for the badges of fraud list or considered as concealment or destruction of records.

On a June webcast an IRS special agent said, "There really is no legitimate business reason to do something like this," adding that the only purpose for using a mixer service is to hide transactions.

"Anything that makes the paper trail — or, in this case, the digital trail — more difficult to unravel will be used by the IRS as evidence to show a guilty mindset," Hochman said. The IRS would argue that there is no reason for a taxpayer looking to comply to further increase anonymity, he said.

However, the analogy to shell companies and offshore accounts will also help in fighting the idea that virtual currency anonymizers are per se fraudulent, Hochman said. Many taxpayers have completely legitimate reasons for holding offshore accounts — including asset protection or keeping money outside the U.S. banking system — that have nothing to do with tax evasion, he said, adding that there is no tax fraud in those situations as long as the accounts are properly disclosed.

Boxerman said that while it's understandable that use of a tumbler is thought to be inherently suspicious, he urged caution because there may be other motivations besides tax fraud. Not only are some people concerned about privacy, but some make the argument that not all illicit motives are tax-related, he said. "There could be other reasons that are non-tax-fraud that perhaps are totally innocent, or perhaps are less innocent but they are still not tax fraud," he said.

For example, a taxpayer may wish to hide assets from a soon-to-be-former spouse, rather than from the IRS.

Kundra agreed that there are plenty of non-tax-fraud reasons for anonymity, and suggested estate planning vehicles as another legitimate reason. A desire for anonymity doesn't mean that the taxpayer won't properly disclose cryptocurrency assets on the relevant tax returns, she said.

Hochman said the IRS is likely to develop a reporting regime for cryptocurrency over the next few years comparable to the one for foreign financial accounts. That regime should be useful for differentiating taxpayers with legitimate secrecy concerns from those with tax evasion motives, he said.

Compared with the market capitalization of more traditional investments such as public stocks, the current total value of cryptocurrencies is a "rounding error," but there is a realistic chance for virtual currencies to become a significant asset, Hochman said. That highlights the importance of creating, publicizing, and enforcing a reporting regime as soon as possible to ease that transition, he said. "We have a new commissioner coming in at some point [and] I think he is very keyed in on this issue," he added.

Charles Rettig of Hochman, Salkin, Rettig, Toscher & Perez PC has been nominated to be IRS commissioner and has been approved by the Senate Finance Committee, but Senate Democrats are trying to delay a floor vote until he answers questions concerning the new cap on state and local tax deductions. Hochman was a principal at Rettig's firm before he became the head of the Tax Division.

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