

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions

September 24, 2020

Reference Number: 2020-30-066

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1=Tax Return/Return Information

2=Law Enforcement Techniques/Procedures and Guidelines for Law Enforcement Investigations or Prosecutions.

7=Information Reflecting the Bureau's Decisionmaking Process

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HIGHLIGHTS: The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions



Final Audit Report issued on September 24, 2020
Reference Number 2020-30-066

Why TIGTA Did This Audit

This audit was initiated because the use of virtual currency as a payment method continues to grow in popularity and is emerging as an alternative asset to U.S. or other fiat currencies. This audit focuses on virtual currency exchanges because they play an important role in the transferability and stability of virtual currency by facilitating the buying and selling of virtual currencies for customers. The overall objective of this review was to evaluate the IRS's efforts to ensure the accurate reporting of virtual currency transactions as required under U.S. Code Titles 26 (Internal Revenue Code) and 31 (Money and Finance).

Impact on Taxpayers

The sale or exchange of virtual currencies, the use of virtual currencies to pay for goods or services, and holding virtual currencies as an investment generally have tax consequences that could result in tax liability. Taxpayers who do not properly report the income tax consequences of virtual currency transactions may be liable for tax, penalties, and interest. In addition to taxpayers' virtual currency transactions, the IRS reviews virtual currency exchanges, which engage in the business of exchanging virtual currency for fiat currency or other virtual currency. While exchanges are in a position to provide important information for use by the IRS in tax administration, information reporting on virtual currency transactions from the exchanges is lacking.

What TIGTA Found

TIGTA found that it is difficult for the IRS to identify taxpayers with virtual currency transactions because of the lack of third-party information reporting that specifically identifies virtual currency transactions. As of October 2018, both the Large Business and International and the Small Business/Self-Employed (SB/SE) Divisions' examination functions have started a small number of examinations of taxpayers based on potential virtual currency issues, and the SB/SE Division's examination function has few known open examinations of virtual currency exchanges.

TIGTA reviewed the examination case files for seven judgmentally sampled virtual currency exchange examinations closed by Bank Secrecy Act (BSA) Program examiners and found that some exchanges exhibited business characteristics that may qualify them as Third-Party Settlement Organizations (TPSOs) under Internal Revenue Code Section 6050W. This would require the filing of Form 1099-K, *Payment Card and Third Party Network Transactions*, for customers with more than 200 transactions in a year that total in excess of \$20,000. However, some of the exchanges that appeared to be TPSOs issued Forms 1099-K for Tax Years 2015 to 2018. Additionally, TIGTA reviewed the Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, filing data for nine virtual currency exchanges for Tax Years 2015 to 2018 and was only able to identify **1** ****1**** that issued Forms 1099-B to its customers for that period.

Although BSA Program examiners generally pursue Title 31 issues, they are encouraged to make referrals to the BSA Examination Case Selection for Title 26 income tax examinations if they identify issues that indicate noncompliance. However, Title 31 examiners did not generally identify income tax issues and refer examinations to Title 26 examination groups. None of the examinations in TIGTA's review had potential Title 26 issues referred.

What TIGTA Recommended

TIGTA recommended that the IRS continue efforts to close the virtual currency information gap by issuing guidance clarifying the proper information reporting associated with virtual currency transactions. TIGTA also recommended that the IRS develop a process to use and monitor Title 31 virtual currency information in Title 26 examination workload.

IRS management agreed with both recommendations. The IRS stated that it is currently working with the Treasury Department to develop guidance on third-party reporting under Internal Revenue Code Section 6045 for certain taxable transactions involving virtual currency. The IRS also stated that an Interim Guidance Memo provides guidance and references a monitored process for a Title 26 examiner to use Title 31 information. In addition, the IRS stated that some Title 31 data was made available to the Title 26 program.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 24, 2020

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

A handwritten signature in blue ink that reads "Michael E. McKenney".

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Can Improve
Taxpayer Compliance for Virtual Currency Transactions
(Audit # 201830034)

This report presents the results of our review to evaluate the Internal Revenue Service's efforts to ensure the accurate reporting of virtual currency transactions as required under U.S. Code Titles 26 and 31. This review is part of our Fiscal Year 2020 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

Management's complete response to the draft report is included as Appendix II.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions

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The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions

Background

Virtual currency is a digital representation of value, other than a representation of the U.S. dollar or a foreign currency (“fiat” currencies), which functions as a unit of account, a store of value, and a medium of exchange.¹ Virtual currencies are stored in “virtual currency wallets” and can be digitally traded between users as well as be purchased for, or exchanged into, U.S. dollars, euros, and other fiat or virtual currencies through a direct peer-to-peer system.² Virtual currencies are often described as “cryptocurrencies” because they use cryptographic protocols to secure transactions recorded on publicly available decentralized ledgers, called “blockchains.”³ Virtual currency that has an equivalent value in fiat currency, or that acts as a substitute for fiat currency, is referred to as “convertible” virtual currency. Bitcoin is one example of convertible virtual currency. Although the value of virtual currency has varied substantially in recent years, as of April 2020, there were over 5,000 virtual currencies with market capitalization exceeding \$214 billion, in addition to unreported virtual currency transactions.⁴

The use of virtual currency as a payment method continues to grow in popularity and is emerging as an alternative asset to U.S. or other fiat currencies.⁵ Making payments in virtual currency, instead of fiat currency, may allow users to pay lower transaction fees and achieve faster transfer of funds. However, the use of virtual currency may also allow anonymity in transactions and the possibility of avoiding tax reporting obligations. Taxation compliance risks can arise from willful conduct by a taxpayer (*e.g.*, using virtual currency to evade taxes) or nonwillful conduct (*e.g.*, lack of understanding of the taxability of virtual currency transactions, calculation of gain/loss from virtual currency transactions, characterization of income, third-party reporting responsibilities, *etc.*).

The Internal Revenue Service’s (IRS) latest estimate of the gross Tax Gap, the amount of tax liability not paid voluntarily and timely, was \$441 billion annually for Tax Years (TY) 2011 through 2013. The gross Tax Gap is comprised of taxpayers who did not timely pay tax and timely file required returns (nonfiling), taxpayers misreporting amounts used to calculate tax liabilities on timely filed returns (underreporting), and taxpayers not paying tax liabilities reported on timely filed tax returns (underpayment). The IRS estimates that these components contribute, on average, \$39 billion, \$352 billion, and \$50 billion, respectively, to the gross Tax Gap annually.

This audit focuses on virtual currency exchanges because they play an important role in the transferability and stability of virtual currency by facilitating the buying and selling of virtual currencies for customers. Unlike U.S. currency, virtual currency is not legal tender that must be

¹ Fiat currency is the name for what is traditionally recognized as currency. Fiat currency is the coin and paper money of a country and designated as its legal tender.

² A “virtual currency wallet” is a means (software application or other mechanism/medium) for holding, storing, and transferring bitcoins or other virtual currency.

³ *Commodity Futures Trading Commission v. McDonnell*, 287 F.Supp.3d 213 (E.D. NY 2018).

⁴ CoinMarketCap, All Cryptocurrencies, available at <https://coinmarketcap.com/all/views/all/> (last visited Apr. 23, 2020). Cryptocurrencychart.com indicates price fluctuations of the top twenty five cryptocurrencies through the years 2010 to 2020.

⁵ IRS, Pub. 5316, *Internal Revenue Service Advisory Council Public Report November 2018* p. 72 (Nov. 2018).



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accepted as payment.⁶ Virtual currency exchanges allow virtual currency to be readily exchanged for legal tender. While these exchanges are in a position to provide important information for use by the IRS in tax administration, information reporting on virtual currency transactions from the exchanges is lacking. The IRS's most recent Tax Gap study, issued in September 2019, found that noncompliance varies with the amount of information reporting by third parties (*e.g.*, employers, banks, partnerships). Items subject to substantial information reporting and withholding (*e.g.*, wages) have a net misreporting rate of 1 percent for the individual income tax. However, the net misreporting rate for items subject to some information reporting (*e.g.*, partnership income) is 17 percent, and the net misreporting rate for items subject to little or no information reporting (*e.g.*, nonfarm proprietor income) is 55 percent.

Tax consequences of virtual currency transactions

The sale or exchange of virtual currencies, the use of virtual currencies to pay for goods or services, and holding virtual currencies as an investment generally have tax consequences that could result in tax liability. In March 2014, the IRS issued Notice 2014-21 as guidance for individuals and businesses on the tax treatment of transactions using virtual currencies.⁷ According to Notice 2014-21, the general tax principles that apply to property transactions also apply to transactions using virtual currency. For example:

- A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.
- A payment made using virtual currency made to independent contractors and other service providers is taxable, and self-employment tax rules generally apply. Normally, payers must issue Form 1099-MISC, *Miscellaneous Income*.
- Wages paid to an employee using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, *Wage and Tax Statement*, and are subject to Federal income tax withholding and payroll taxes.
- Virtual currency may be used to pay for goods or services. Certain third parties who settle payments made in virtual currency on behalf of merchants that accept virtual currency from their customers are required to report payments to those merchants on Form 1099-K, *Payment Card and Third Party Network Transactions*.
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

In October 2019, the IRS issued Revenue Ruling 2019-24, which offered guidance on the income tax consequences of "airdrops" and "hard forks."⁸ The IRS also expanded upon the examples provided in Notice 2014-21 by providing a series of frequently asked questions on its website to assist taxpayer reporting of virtual currency tax matters.⁹ In another important initiative, the IRS

⁶ 31 United States Code (U.S.C.) Section (§) 5103.

⁷ IRS, IRS Notice 2014-21, *IRS Virtual Currency Guidance*; 2014-16 I.R.B. p. 938.

⁸ IRS, IRS Rev. Rul. 2019-24; 2019-44 I.R.B. p. 1004. An "air drop" involves the distribution of virtual currency to users, and a "hard fork" involves the splitting of a blockchain into incompatible versions of the currency.

⁹ IRS, *Frequently Asked Questions on Virtual Currency Transactions*, dated Dec. 2019, available at <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> (last visited July 22, 2020).



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created a question on Schedule 1, *Additional Income and Adjustments to Income*, for the TY 2019 Form 1040, *U.S. Individual Income Tax Return*, asking whether taxpayers have received, sold, sent, exchanged, or acquired an interest in virtual currency. If taxpayers answer truthfully, the question provides some information to the IRS about risks related to tax compliance coming from virtual currencies; however, the question does not require taxpayers to provide the nature and extent of such transactions that, if provided, would give the IRS a more complete understanding of tax compliance risk related to virtual currency transactions.

Taxpayers who do not properly report the income tax consequences of virtual currency transactions may be liable for tax, penalties, and interest. In some cases, taxpayers could be subject to criminal prosecution. In addition to taxpayers' virtual currency transactions, the IRS reviews virtual currency exchanges, which engage in the business of exchanging virtual currency for fiat currency or other virtual currency.

Federal oversight of virtual currencies

There is concurrent oversight involving virtual currencies among Federal agencies. The Commodity Futures Trading Commission has asserted jurisdiction over transactions involving virtual currencies, treating them as commodities.¹⁰ The U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) has authority over money service businesses (MSBs) with reporting obligations under the Bank Secrecy Act (BSA).¹¹ FinCEN exercises regulatory functions primarily under the Currency and Foreign Transactions Reporting Act of 1970, as amended by other legislation, a legislative framework commonly referred to as the BSA.

Congress enacted the BSA in 1970 to fight money laundering and other financial crimes. The BSA authorizes the Secretary of the Treasury to issue regulations requiring banks and other financial institutions to take a number of precautions against financial crime, including the establishment of anti-money laundering programs and the filing of reports that have been determined to have a high degree of usefulness in criminal, tax, and regulatory investigations and proceedings and certain intelligence and counter-terrorism matters. Virtual currency exchanges are deemed MSBs under FinCEN regulations.¹²

The IRS oversees enforcement of the taxable implications of virtual currency transactions.¹³ The IRS's Large Business and International (LB&I) Division and Small Business/Self-Employed (SB/SE) Division jointly have responsibility for virtual currency tax compliance. In July 2018, the LB&I Division announced a Virtual Currency Compliance campaign led by its Withholding and International Individual Compliance practice area.¹⁴ The campaign aims to address

¹⁰ The Commodity Futures Trading Commission oversees "accounts, agreements ... and transactions involving swaps or contracts of sale of a commodity for future delivery..." 7 U.S.C. § 2. See also Government Accountability Office, *Virtual Currencies: Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance* (Feb. 2020), and *Commodity Futures Trading Commission v. McDonnell*, 287 F. Supp. 3d 213 (E.D. NY 2018).

¹¹ Pub. L. No. 91-508, 84 Stat. 1114 to 11244 (1970) (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C., and 31 U.S.C.). Regulations for the Bank Secrecy Act, and other related statutes, are 31 C.F.R. 103.11-103.77 (2010).

¹² FIN-2013-G001.

¹³ As described above, the IRS has issued one notice and one revenue ruling providing guidance on the taxation of virtual currencies.

¹⁴ The Withholding and International Individual Compliance practice area has responsibility for the following taxpayers: U.S. citizens living or working abroad or in a U.S. Territory, U.S. citizens or resident aliens who hold income-producing assets in a foreign country or claim the foreign earned income exclusion or foreign tax credit, and permanent residents and nonresident aliens who have a U.S. filing requirement.



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noncompliance related to the use of virtual currency through multiple treatment streams, including outreach and examinations. The intended compliance outcomes of the LB&I Division's Virtual Currency Compliance campaign include:

- Identify causes of noncompliance through a feedback loop and examination results.
- Identify additional treatment streams to increase compliance and reduce taxpayer burden.
- Improve examiner knowledge and skills as related to virtual currency transactions.
- Assist in developing a comprehensive IRS virtual currency strategy.

The LB&I Division's Virtual Currency Compliance campaign includes approved treatment streams such as soft letter(s), issue-based examinations, external events, and outreach. The Campaign has implemented virtual currency examination field work through third-party information reports.

The SB/SE Division has two different examination functions that may encounter virtual currency issues during examinations. The SB/SE Division's Specialty Examination function maintains a BSA Program, which conducts reviews under Title 31 (Money and Finance) of the United States Code (U.S.C.) as well as under provisions of U.S.C. Title 26 (Internal Revenue Code (I.R.C.) Section (§) 6050I).¹⁵ FinCEN has delegated responsibility for Title 31 compliance to the BSA Program.

The SB/SE Division's Field Examination program conducts taxpayer audits under Title 26 of the U.S.C. (Internal Revenue Code). The BSA Program, with only 237 full-time equivalents in Fiscal Year (FY) 2017, is significantly smaller than the SB/SE Division's Field Examination function, with 5,225 full-time equivalents.¹⁶

In a September 2018 report, we found that, for FYs 2014 through 2016, the BSA Program had estimated labor expenses of approximately \$97 million, which resulted in assessing only \$39 million in BSA-related penalties.¹⁷ We also found that systemic delays associated with the FinCEN penalty referral process resulted in only 80 cases referred to FinCEN and six penalties assessed by FinCEN from 24,212 BSA cases worked for FYs 2014 through 2016 and that the BSA Program's Title 31 compliance reviews appeared to be having little impact because of the IRS's lack of penalty authority.¹⁸ Our report made five recommendations, including that the IRS coordinate with FinCEN on the authority to assert Title 31 penalties or reprioritize resources to more productive work. The IRS did not agree with this recommendation, stating that the action was outside its purview and FinCEN intended to retain this authority. The Acting Inspector General of the Treasury, with oversight authority over FinCEN, made an observation similar to TIGTA's September 2018 report finding about Title 31 penalty authority in testimony at a 2004 hearing on money laundering and terrorism financing by stating that an October 2002 audit

¹⁵ I.R.C. § 6050I requires that any person engaged in a trade or business that receives in the course of such trade or business more than \$10,000 in cash must make a report to the Government as required by the statute.

¹⁶ Full-time equivalent is the total number of regular straight-time hours (*i.e.*, not including overtime or holiday hours) worked by employees divided by the number of paid hours applicable to each fiscal year. Annual leave, sick leave, compensatory time off, and other approved leave categories are considered to be "hours worked" for purposes of defining full-time equivalent employment. Full-time equivalent figures reported in IRS SB/SE Division, Small Business/Self-Employed Business Performance Review, 4th Quarter FY 2017 (Nov. 2017).

¹⁷ TIGTA, Ref. No. 2018-30-071, *The Internal Revenue Service's Bank Secrecy Act Program Has Minimal Impact on Compliance* (Sept. 2018).

¹⁸ The penalty related to the Report of Foreign Bank and Financial Accounts under 31 U.S.C. § 5314 is the only Title 31 penalty for which assessment authority has been delegated to the IRS.



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found that FinCEN was inconsistent and untimely in its enforcement actions against casinos for BSA violations referred by the IRS.¹⁹ The testimony expressed the concern that the IRS might be reluctant to refer future casino BSA violations to FinCEN.

The Government Accountability Office (GAO) recently reviewed the IRS's efforts to ensure compliance with tax obligations for virtual currencies.²⁰ The GAO found that the IRS has limited data on tax compliance for virtual currencies because of limited information reporting by third parties, such as financial institutions. The GAO also found that many virtual currency transactions likely go unreported to the IRS, due in part to unclear requirements and thresholds that limit the number of virtual currency users subject to third-party reporting.

Results of Review

Due to limited information reporting that specifically identifies virtual currency transactions, the IRS cannot easily identify taxpayers with virtual currency transactions. In addition, few examinations of virtual currency exchanges are conducted by either Title 26 Field Examination groups or Title 31 BSA Program examination groups.

Limited Guidance on Virtual Currency Information Reporting Obligations Impacts Tax Compliance

Tax compliance is higher when there is third-party information reporting provided to the IRS on income earned with respect to a taxpayer. The IRS estimates that tax compliance is approximately 95 percent when there is substantial information reporting, and when there is substantial information reporting combined with tax withholding, tax compliance is estimated to be 99 percent.²¹ However, tax compliance drops to 45 percent when there is little or no information reporting or withholding.

Currently, there is an information reporting gap for virtual currency transactions.

Currently, there is an information reporting gap for virtual currency transactions because many such transactions are not reported to the IRS, and the transactions that are reported are not reported specifically as virtual currency transactions. Under existing IRS guidance, some virtual currency transactions are required to be reported in certain situations. However, there are two essential problems with virtual currency transaction reporting.

First, as the Treasury Inspector General for Tax Administration (TIGTA) reported in September 2016, third-party reporting of taxable transactions to the IRS does not separately identify transactions related to virtual currency.²² Employers and businesses are required to report taxable virtual currency transactions on information reporting documents such as

¹⁹ *Money Laundering and Terrorism Financing, Hearing Before the H. Comm. on Financial Services, 108th Cong. (2004)* (statement of Dennis S. Schindel, Acting Inspector General, Department of Treasury).

²⁰ GAO, GAO-20-188, *Virtual Currencies: Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance* (Feb. 2020).

²¹ IRS, Pub. 1415, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011–2013* (2019).

²² TIGTA, Ref. No. 2016-30-083, *As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance* (Sept. 2016).



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Form W-2 (when virtual currency is paid to employees), Form 1099-MISC (generally when virtual currency is paid of \$600 or more in settlement of services provided by an entity in a trade or business), and Form 1099-K (which will be described more fully below). However, these information returns currently do not provide any specific way to identify that the taxable transaction amounts being reported are related to virtual currencies. TIGTA recommended in its September 2016 report that the IRS's Deputy Commissioner for Services and Enforcement should revise third-party information reporting documents to identify the amounts of virtual currency used in taxable transactions. The IRS agreed with TIGTA's recommendation but stated that modifying information reporting documents to capture virtual currency amounts was not a priority for the IRS.

Second, as we describe in more detail below, while there is clarity that Form 1099-K must be provided to the IRS for certain limited virtual currency transactions, the information reporting requirements do not apply to all virtual currency exchanges. Another information reporting form, Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions* (which is required to be filed for broker-related transactions), may be available to report virtual currency transactions. As discussed later in this report, the IRS and Department of the Treasury are currently considering whether to issue guidance relating to reporting virtual currency transactions under I.R.C. § 6045, which governs information reporting by brokers.

Not all virtual currency exchanges are required to report transactions on Form 1099-K

I.R.C. § 6050W requires reporting of certain payments made in settlement of payment card and third-party network transactions.²³ A "third-party payment network" is any agreement or arrangement that:

- Involves the establishment of accounts with a central organization by a substantial number of persons (*e.g.*, more than 50) who are unrelated to such organization, provide goods or services, and have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement.
- Provides for standards and mechanisms for settling such transactions.
- Guarantees persons providing goods or services pursuant to such agreement or arrangement that such person will be paid for providing such goods or services.

I.R.C. § 6050W requires any "payor," or payment settlement entity, making one or more payments to a participating payee in settlement of "reportable payment transactions" to file Form 1099-K annually with the IRS. The payor reports the gross amount of such reportable payment transactions for the calendar year and for each month within such calendar year. The payor must also report the name, address, and Taxpayer Identification Number of the participating payees on Form 1099-K.²⁴

Virtual currency exchanges may be considered third-party settlement organizations (TPSOs) to the extent they settle payments made in virtual currency on behalf of merchants that accept virtual currency. A TPSO is a central organization that has a contractual obligation to make

²³ I.R.C. § 6050W requires payment settlement entities to issue Form 1099-K statements to payees who meet the criteria of I.R.C. § 6050W(e). Section 3091 of the Housing and Economic Recovery Act of 2008 (Pub. L. 110-289) added I.R.C. § 6050W.

²⁴ A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the Taxpayer Identification Number is an Employer Identification Number, a Social Security Number, or an Individual Taxpayer Identification Number.



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payments to participating payees (generally, a merchant or business) in a third-party payment network.

Under the reporting requirements, the TPSOs must report the gross reportable transactions of the businesses to which they make payments provided the payee satisfies certain transaction volume and dollar thresholds. In general, the TPSOs are required to file Form 1099-K when the gross amount of total reportable payment transactions exceeds \$20,000 and the total number of such transactions exceeds 200 for the calendar year.²⁵ IRS guidance provides that certain third parties who settle payments made in virtual currency on behalf of merchants that accept virtual currency from their customers are required to report payments to those merchants on Form 1099-K.²⁶ IRS officials told us that it is unclear under the current rules whether virtual currency that is exchanged for fiat currency (or for another type of virtual currency) would be considered “goods or services” under the reporting rules of I.R.C. § 6050W. Our review of Form 1099-K filings by a judgmental sample of virtual currency exchanges in Figure 1 shows that these exchanges may be taking inconsistent positions from one another on information reporting requirements.²⁷ Figure 1 below shows that only four of these exchanges issued any Forms 1099-K in TYs 2015 to 2018, despite most having 30-day exchange volumes ranging from hundreds of millions to billions of dollars.

**Figure 1: Forms 1099-K Filed for Virtual Currency Exchanges
TYs 2015 to 2018**

	30-Day Exchange Volume ²⁸	Number of Forms 1099-K Issued			
		TY 2015	TY 2016	TY 2017	TY 2018
Exchange A	**1*²⁹	78	41	11,298	7,416
Exchange B	**1**	0	0	0	0
Exchange C	**1**	0	0	0	0
Exchange D	**1**	0	0	0	0
Exchange E	**1**	0	0	0	0
Exchange F	**1**	14	76	1,437	940
Exchange G	**1**	0	0	0	0
Exchange H	**1**	0	0	0	1
Exchange I	Not on Top 100 Lists	0	0	210	0

Source: TIGTA analysis of IRS Form 1099-K filing data.

The BSA Program examines certain MSBs, as well as other businesses, for compliance with the BSA (U.S.C. Title 31), which requires that certain transactions be reported, as well as I.R.C. § 6050I

²⁵ I.R.C. § 6050W.

²⁶ IR-2018-71, March 23, 2018.

²⁷ A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

²⁸ Exchange volume from <https://coinmarketcap.com/rankings/exchanges>, as of January 13, 2020.

²⁹ This exchange volume represents a minimum amount based on a subsidiary of a parent company.



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(U.S.C. Title 26). However, examining virtual currency exchanges has made up a small part of the BSA Program’s work plan, as we describe further below.

We reviewed the examination case files for seven judgmentally sampled virtual currency exchange examinations closed by BSA Program examiners and found that three exchanges exhibited business characteristics that may qualify them as TPSOs under I.R.C. § 6050W, which would require the filing of Form 1099-K for customers with more than 200 transactions in a year that total in excess of \$20,000. We reviewed the contents of the seven Title 31 case files, including examination results, summaries, notes, and any attached information, to assess whether an exchange exhibited the characteristics or activity of a TPSO. The case files for three exchanges showed the following characteristics of a TPSO as outlined in I.R.C. § 6050W:

- The existence of a central organization with whom a substantial number of persons providing goods and services (who are unrelated to the central organization) have established accounts.
- An agreement between the central organization and the persons to settle transactions for the provision of goods or services.
- The establishment of standards and mechanisms for settling such transactions.
- The guarantee of payment in settlement of such transactions.

*****1*****
 *****1*****
 *****1*****
 *****1*****
 *****1***** According to these exchanges, they have been active in over 100 countries, with 1 million to over 30 million customers, and have exchanged more than \$4 billion to over \$150 billion in transactions.

We also researched other large exchanges not included in our sample that were based in the United States and exchanged virtual currency for U.S. fiat currency. We found *****1***** had issued Forms 1099-K in at least one of the years between TYs 2015 to 2018. The **1** *****1*****

The IRS should require virtual currency exchanges to file Form 1099-B to disclose virtual currency transactions

Brokers are required to file Form 1099-B with the IRS to report transactions on behalf of customers. Form 1099-B instructions define brokers as “any person who, in the ordinary course of a trade or business, stands ready to effect sales to be made by others.”³⁰ Brokers who sell commodities are included in the requirement to issue Forms 1099-B to customers.³¹

³⁰ IRS, 2020 Instructions for Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions* (Nov. 18, 2019), available at <http://www.irs.gov/pub/irs-pdf/i1099b.pdf>.

³¹ The I.R.C. § 6045(g)(3)(B)(iii) definition of specified security includes a commodity, thereby requiring commodity brokers to issue Form 1099-B to customers for commodity transactions. Commodities are subject to Form 1099-B reporting due to the application of Treas. Reg. §1.6045-1(c)(1) (brokers must report on “sales”) and Treas. Reg. § 1.6045-1(a)(9) (definition of “sales” includes disposition of commodities).



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At least one Federal court has held that virtual currencies are “commodities” for purposes of being subject to Commodity Futures Trading Commission regulations. In *Commodity Futures Trading Commission v. McDonnell*, the U.S. District Court for the Eastern District of New York noted that commentators argue: “Bitcoin should primarily be considered a commodity because it serves the function of money in its community of users.”³² One legal commentator has opined that virtual currency exchanges are already required to file Form 1099-B, while one executive of a virtual currency exchange suggested that rather than having the IRS serve John Doe Summons to obtain client information, the IRS should just require exchanges to file Forms 1099-B.³³

The GAO’s February 2020 report stated that the IRS does not have an official position about whether virtual currency exchanges are required to report customer trading activity on Form 1099-B. The GAO also reported that it was only able to identify one exchange that stated that it reports customers’ transactions on Form 1099-B. TIGTA reviewed Form 1099-B filing data for the nine virtual currency exchanges in Figure 1 for TYs 2015 to 2018. As shown in Figure 2 below, we were also only able to identify one exchange that issued Forms 1099-B to its customers for that period.

**Figure 2: Forms 1099-B Filed for Virtual Currency Exchanges
TYs 2015 to 2018**

	30-Day Exchange Volume	Number of Forms 1099-B Issued			
		TY 2015	TY 2016	TY 2017	TY 2018
Exchange A	**1** ³⁴	0	0	0	0
Exchange B	**1**	0	0	0	0
Exchange C	**1**	0	0	0	0
Exchange D	**1**	0	0	0	0
Exchange E	**1**	0	0	0	0
Exchange F	**1**	0	0	0	0
Exchange G	**1**	103,414	194,532	412,720	642,402
Exchange H	**1**	0	0	0	0
Exchange I	Not on Top 100 Lists	0	0	0	0

Source: TIGTA analysis of IRS Form 1099-B filing data.

The 2019–2020 Priority Guidance Plan issued by the Department of the Treasury and the IRS in October 2019 includes “Guidance regarding information reporting on virtual currency under

³² *Commodity Futures Trading Commission v. McDonnell*, 287 F. Supp. 3d 213 (E.D. NY 2018), holding that Commodity Futures Trading Commission had jurisdiction over virtual currencies for purposes of issuing injunction to virtual currency exchange.

³³ *Digital Money: Bitcoin’s Financial and Tax Future Despite Regulatory Uncertainty*, 64 DePaul L. Rev. 213, 242 (2014). *Bitcoin: Breaking Bad or Breaking Barriers?*, 18 N.C. J.L. & Tech. On. 244, 255-256 (2017). There are times when the IRS must investigate violations, or potential violations, of Internal Revenue law by a person, group, or class of persons without identifying a specific individual. A John Doe summons is a summons that does not identify the person with respect to whose liability the summons is issued. Internal Revenue Manual 25.5.7.1.1 (June 4, 2020). I.R.C. § 7609(f) governs the requirements of an IRS-issued John Doe summons.

³⁴ This exchange volume represents a minimum amount based on a subsidiary of a parent company.



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Section 6045” under the area of Tax Administration. I.R.C. § 6045 currently addresses reporting of securities, commodities, and other property but not specifically virtual currency. Based on TIGTA’s discussion with IRS Counsel, any future virtual currency guidance pertaining to I.R.C. § 6045 will address the types of third-party information reporting documents the exchanges should be issuing. *****2***** In our discussion, IRS Counsel agreed that forms allowing taxpayers to identify virtual currency transactions would be beneficial.

The IRS cannot easily identify taxpayers with virtual currency transactions because of the lack of third-party information reporting that specifically identifies virtual currency transactions. An information reporting regime that requires all virtual currency exchanges to report all virtual currency transactions to the IRS would benefit tax compliance by closing the information gap with respect to virtual currencies.

Recommendation 1: The Deputy Commissioner for Services and Enforcement should continue efforts to close the virtual currency information gap by issuing guidance clarifying the proper information reporting associated with virtual currency transactions.

Management’s Response: The IRS agreed with this recommendation. In its response, the IRS stated that it is currently working with the Department of the Treasury to develop guidance on third-party reporting under I.R.C. § 6045 for certain taxable transactions involving virtual currency.

Few Title 26 Examinations Involving Virtual Currency Exchanges Were Conducted

As of October 2018, both the LB&I and SB/SE Divisions’ Examination functions started a small number of examinations of taxpayers based on potential virtual currency issues. These taxpayers were primarily identified from external information. These are considered to be pilot examinations that may help form policies, procedures, and processes for obtaining virtual currency data and performing examinations.

As of October 2018, both the LB&I and SB/SE Divisions’ Examination functions have started a small number of examinations of taxpayers based on potential virtual currency issues.

The IRS issued a “John Doe” summons in 2016 on Coinbase Inc., a virtual currency exchange headquartered in San Francisco, California. According to the summons, at the time, Coinbase offered buy and sell trading functionality in 33 countries, with 5.9 million customers served and \$6 billion in virtual currency exchanged. In November 2016, a Federal court in the Northern District of California authorized the IRS to file a John Doe summons on Coinbase for information on U.S. taxpayers who conducted transactions in a convertible virtual currency during Calendar Years 2013 to 2015. Coinbase failed to comply with the summons, and in March 2017, the IRS filed a petition to enforce the summons issued to Coinbase.³⁵

³⁵ *United States of America v. Coinbase Inc.*, Declaration of David Utzke in Support of Petition to Enforce Internal Revenue Summons, Case 3:17-cv-01431-JSC (N.D. Cal.).



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To support the John Doe summons, the IRS analyzed electronically filed Forms 8949, *Sales and Other Dispositions of Capital Assets*, from the Modernized Tax Return Database for TYs 2013 through 2015.³⁶ The analysis indicated that only a small number of Forms 8949 included reports of property descriptions that were likely related to Bitcoin each year. For example, almost 129 million returns were electronically filed for TY 2015, and the IRS's search for Form 8949 data identified only 802 individuals who reported a transaction using a property description likely related to Bitcoin for that tax year.

Other than its involvement in LB&I Division's examinations, SB/SE Division's Field Examination function has few known open examinations of virtual currency exchanges. In 2018, the LB&I Division announced a Virtual Currency Compliance campaign with the objective of addressing noncompliance related to the use of virtual currency through multiple treatment streams, including outreach and examinations. The LB&I Division's Virtual Currency Compliance campaign announcement urged taxpayers with unreported virtual currency transactions to correct their returns as soon as practical because it is not contemplating a voluntary disclosure program specifically to address noncompliance involving virtual currency.

In July 2019, the IRS began sending educational letters to more than 10,000 taxpayers with virtual currency transactions that potentially failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions properly. The stated purpose of the mailings was to help taxpayers understand their tax and filing obligations and how to correct past errors. The following three variations of letters were mailed to the taxpayers: Letter 6173, *Virtual Currency Soft Notice*; Letter 6174, *Virtual Currency Education*; and Letter 6174-A, *Virtual Currency Education-Plus*.

- Letter 6173 required a response from the taxpayer. If the taxpayer does not timely respond, the IRS may consider an audit of the taxpayer.
- Letters 6174 and 6174-A do not require a response; however, an LB&I Director of Field Operations noted that the IRS still conducts risk assessments at that level and does not rule out auditing a taxpayer.³⁷

Regarding the letters, IRS Commissioner Chuck Rettig stated:

*Taxpayers should take these letters very seriously by reviewing their tax filings and, when appropriate, amend past returns and pay back taxes, interest, and penalties. The IRS is expanding our efforts involving virtual currency, including increased use of data analytics. We are focused on enforcing the law and helping taxpayers fully understand and meet their obligations.*³⁸

The SB/SE Division has conducted only a small number of Title 26 examinations of virtual currency exchanges

During our review, SB/SE Division officials informed us that, as of October 2018, they were not able to identify any known open Title 26 examinations of virtual currency exchanges. Therefore, we selected a judgmental sample of eight U.S.-based virtual currency exchanges that use U.S. fiat currency as a form of exchange to determine if any Title 26 examinations had been

³⁶ The Modernized Tax Return Database is the legal repository for original electronically filed returns received by the IRS through the Modernized e-File system.

³⁷ Andrew Velarde, "Taxpayers Can Expect More Virtual Currency Compliance Letters," Tax Notes Today, Oct. 23, 2019.

³⁸ IR-2019-132, July 26, 2019.



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conducted on these exchanges from FYs 2015 to 2019. Figure 3 shows the names, number of markets, and 30-day transaction volume for the U.S.-based exchanges that we selected for our review.

Figure 3: U.S.-Based Virtual Currency Exchanges Selected for TIGTA’s Review of Title 26 Examination Activity

Exchange	Number of Markets	30-Day Transaction Volume
Exchange A ³⁹	*1*	***1***
Exchange B	*1*	***1***
Exchange C	*1*	***1***
Exchange D	*1*	***1***
Exchange E	*1*	***1***
Exchange F	*1*	***1***
Exchange G	*1*	***1***
Exchange H	*1*	***1***

Source: <https://coinmarketcap.com/rankings/exchanges/> (last visited Jan. 13, 2020).

We researched these exchanges in the IRS’s Audit Information Management System to determine if the IRS has conducted any Title 26 examinations on these exchanges from FY 2015 to FY 2019.⁴⁰ We found that examinations were selected for three of the eight exchanges in this five-year period. However, for these three exchanges as of the first quarter of FY 2020, *1*

 *****|*****
 *****|*****

[Only a Small Number of Virtual Currency Exchange Examinations Were Conducted by the Small Business/Self-Employed Division’s Bank Secrecy Act Program](#)

The BSA requires that financial institutions retain records and file reports on transactions above certain thresholds as well as report suspicious activities. These reports are submitted to FinCEN, which collects and analyzes the information to support law enforcement investigative efforts and provide U.S. policy makers with strategic analyses of domestic worldwide money laundering developments, trends, and patterns. The BSA’s reporting and recordkeeping provisions apply to banks, savings and loans, and credit unions as well as other financial institutions, including the MSBs, which can include convenience stores that enable customers to purchase money orders as well as other businesses that engage in similar services.

³⁹ The number of markets and the exchange volume represent a minimum amount based on a subsidiary of a parent company.

⁴⁰ The Audit Information Management System is an inventory of IRS examination cases; the system traces examination results through final determination of tax liability including Appeals and Tax Court.



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The SB/SE Division's BSA Program examines whether these financial institutions, including the MSBs, are complying with reporting and recordkeeping provisions. The compliance requirements of the BSA include:

- Registering with FinCEN as an MSB.
- Preparing, implementing, and maintaining a written Anti-Money Laundering compliance program.
- Filing BSA reports, including Suspicious Activity Reports and Currency Transaction Reports.
- Maintaining records for certain types of transactions.
- Obtaining customer identification information sufficient to comply with Anti-Money Laundering requirements.

Additionally, a virtual currency transmitter that is a U.S. person must comply with all U.S. Treasury Office of Foreign Assets Control financial sanctions obligations.

In a February 2018 response to a letter from U.S. Senator Ron Wyden inquiring about FinCEN's virtual currency oversight, FinCEN stated that virtual currency exchanges must register as MSBs. The letter reiterated that virtual currency exchanges have been subject to the BSA since 2011. The letter stated that, as of February 2018, approximately one-third of the 100 virtual currency exchanges have been examined by FinCEN since 2014 in cooperation with the SB/SE Division.

A FinCEN Advisory states that foreign virtual currency exchanges doing business in the United States must register as MSBs with FinCEN.⁴¹ FinCEN noted that some foreign virtual currency exchanges purposely seek to operate outside of the United States to avoid U.S. regulatory oversight in favor of jurisdictions that lack or have limited anti-money laundering/countering the financing of terrorism controls. In addition, global collaboration between 37 countries takes place through the Financial Action Task Force, an inter-governmental body established in 1989 by the Ministers of its Member jurisdictions. Its objectives are to set standards and promote effective implementation of legal, regulatory, and operational measures for combating money laundering, terrorist financing, and other related threats to the integrity of the international financial system.

In June 2019, the Financial Action Task Force issued new requirements for virtual currency exchanges to share customer information with one another when transferring funds. According to the U.S. Secretary of the Treasury, virtual currency exchanges will be required under the new guidance to implement the same anti-money laundering/countering the financing of terrorism requirements as traditional financial institutions. Virtual currency exchanges will be required to:

- Identify who they are sending funds on behalf of, and who is the recipient of those funds.
- Develop processes whereby they are required to share that information with other providers of virtual assets and law enforcement.
- Know their customers and conduct proper due diligence to ensure that they are not engaging in illicit activity.

⁴¹ Advisory FIN-2019-A003.



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- Develop risk-based programs that account for the risks in their particular type of business.

In addition, the Financial Action Task Force requires participating countries to:

- Assess and mitigate the risks associated with virtual asset activities and service providers.
- License or register service providers and subject them to supervision or monitoring by competent national authorities and implement sanctions and other enforcement measures when service providers fail to comply with their (anti-money laundering/countering the financing of terrorism) obligations.
- Underscore the importance of international cooperation.

According to the Financial Action Task Force, some countries may decide to prohibit virtual asset activities based on their own assessment of the risks and regulatory context or to support other policy goals.

The SB/SE Division's BSA Program organizes its work plans under Title 31 and Form 8300 Examinations.⁴² The BSA Examination Case Selection function uses the Title 31 Non-Bank Financial Institution database to monitor virtual currency examinations. The BSA Examination Case Selection function is responsible for delivering an inventory of Non-Bank Financial Institutions subject to the BSA and regulations for which the IRS has been delegated authority to examine. The types of sources used to identify Non-Bank Financial Institutions include:

- External databases.
- Field referrals (referrals may require a related statute determination).
- BSA examiner referrals resulting from physical observation or review of competitor listings.
- FinCEN Query results.
- Neighborhood publications.
- Trade or business associations.
- IRS Research, Applied Analytics, and Statistics.
- BSA Compliance Department, Detroit special reports.
- Internet research.
- State and local licensing and/or regulatory agencies.
- Criminal Investigation referrals.
- MSB agent lists received from examiners and FinCEN.
- FinCEN referrals.
- Referrals from Federal, State, or local law enforcement agencies.

However, as of October 2018, BSA Policy officials were not aware of any policies or procedures for obtaining third-party information reporting on U.S. taxpayers from foreign-based exchanges.

⁴² The IRS has the authority to examine nonfinancial trades and businesses for compliance with the reporting requirements for Form 8300, *Report of Cash Payments Over \$10,000 Received in a Trade or Business*, under Titles 26 and 31.



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According to the IRS, one of the primary data sources used to identify virtual currency examination leads for the BSA Program is a list of possible exchanges for examination and information received from FinCEN. The IRS noted that the BSA Program has started using external vendors who provide blockchain analytic tools to develop techniques to identify virtual currency exchanges. The IRS informed us that the BSA Program is also working with IRS Research, Applied Analytics, and Statistics staff to implement data staging and analytics for all BSA workstreams, including virtual currency.

Since FY 2016, the Title 31 program workstreams have included virtual currency examinations, including virtual currency exchanges. However, the bulk of Title 31 examination work for FY 2019 and FY 2020 consists of noncentralized small MSBs, although the SB/SE Division included some virtual currency exchanges in its FY 2019 examination plan.****2****

*****2*****7*****
 *****2*****7*****
 *****2*****7***** The FY 2020 Title 31 examination plan included 49 planned virtual currency examination starts and 34 planned virtual currency examination closures. However, as shown in Figure 4, virtual currency examinations make up less than 1 percent (12 of 3,392) of planned Title 31 examination closures for FY 2019 and slightly over 1 percent (34 of 3,063) for FY 2020 planned closures.

*****2*****
 *****2*****

*****2*****	**2** **2** **2**	**2** **2** **2**	**2** **2** **2**	**2** **2** **2** 43
*****2*****	**2**	**2**	**2**	**2**
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*****2*****	**2**	**2**	**2**	**2**
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*****2*****	**2**	**2**	**2**	**2**
*****2*****	**2**	**2**	**2**	**2**
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*****2*****

⁴³ FY 2020 Closures to Date as of June 18, 2020.



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In September 2018, TIGTA issued a report evaluating the impact of IRS's compliance efforts related to its delegated authority under the BSA. One of the recommendations was that the IRS leverage the BSA Program's Title 31 examination authority by incorporating its annual examination planning into the IRS's overall virtual currency strategy. The IRS agreed with the recommendation and is in the process of making virtual currency exchange examinations a significant part of its Title 31 examination plan. IRS management indicated that measuring closures by themselves does not reflect the resources applied to an emerging area such as virtual currency. The challenges of expending resources and time to introduce a new workstream, such as virtual currency, include:

- Workload identification and delivery.
- Training of examiners, including developing training materials, delivering classroom training, and on-the-job training with instructors.
- Balancing competing priorities and completing existing examination inventories.
- External factors, such as COVID-19, which impact potential closure of cases from examination groups.

The SB/SE Division has trained additional examiners to increase its examination coverage

As previously stated, TIGTA reviewed seven Title 31 examinations of virtual currency exchanges that were closed between December 2017 and February 2019 to evaluate the BSA Program's Title 31 compliance efforts and whether any referrals were made to the Title 26 examination function as a result of a Title 31 examination. The seven examinations averaged 187 examiner hours per case and generally covered an exam period of 180 days. Five of the seven examinations we reviewed were conducted by examiners at the General Schedule (GS) 13 level, and two examinations were conducted by an examiner at the GS-12 level or lower but with assistance from another examiner. According to IRS officials, the SB/SE Division BSA Program, in consultation with FinCEN, created virtual currency training and trained 18 examiners and managers in FY 2018 and 25 examiners and managers in FY 2019. As of June 2020, the SB/SE Division BSA Program has 64 virtual currency examinations open, which reflects increased resources directed at this high-risk industry.

When no BSA violations are found, the examiner issues the closing Letter 4029, *Bank Secrecy Act No Change Letter*. Letter 4029 states that no violations were identified during the examination period based on the scope and depth of the examination and the evaluation and testing of the implementation of the exchange's anti-money laundering compliance program. One case in our review reported no violations, one case was closed as a survey (no contact with the taxpayer), and five cases were closed with violations found.

Letter 1112, *Title 31 Violation Notification Letter*, is issued to the exchange if BSA violations are found, regardless if such violations meet the criteria for referral to FinCEN under the Internal Revenue Manual (IRM) referral guidelines. FinCEN also gets courtesy copies of all Letters 1112 issued by the IRS. Letter 1112 explains that the examination identified apparent weaknesses or deficiencies related to, or violations of, the BSA. Four examinations in our sample received Letter 1112 upon closure of examination outlining violations involving the areas of policies, procedures, controls, or program requirements. In addition, two exchanges had reporting and recordkeeping violations and failure to file Suspicious Activity Reports. One other case



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exhibited conflicting information on the type of closure. The case file contained a Letter 4029 but also listed violations and referred to the issuance of Letter 1112.

Title 31 examiners did not make a significant number of FinCEN referrals

The BSA generally requires financial institutions to maintain records and to file reports that are useful in criminal, tax, or regulatory investigations, such as money laundering cases. Failure to develop and implement an anti-money laundering program, file BSA reports, or maintain records may result in criminal and/or civil penalties, depending on the nature of the violation. Criminal investigations are the responsibility of IRS Criminal Investigation, and FinCEN has the ability to assess civil penalties. BSA examiners are required to discuss any apparent violations with their manager to determine if the violations should be referred to FinCEN for consideration of penalties or other action. However, only one case from our sample had a FinCEN referral. The referred exchange failed to take corrective actions and did not sign an agreement to follow IRS recommendations and to correct anti-money laundering program, reporting, and recordkeeping violations.

The decision to refer a case to FinCEN depends upon the facts and circumstances of each case. The general standard for a FinCEN referral is significant BSA violation(s) or anti-money laundering program deficiencies. This, along with indications of willful blindness or recklessness, may warrant a referral to FinCEN. However, isolated first incidences of noncompliance normally should not be referred to FinCEN.

Generally, FinCEN disposes of many of its civil penalty cases with one of three courses of action:

- Close the case without contacting the subject of the referral.
- Issue a letter of warning or caution to the subject institution or individual.
- Assess a civil monetary penalty.

After receiving a referral, FinCEN's role includes evaluating the circumstances of the alleged violation(s) and determining whether some type of civil action, including seeking the imposition of a civil monetary penalty, should be taken against the person or financial institution.

TIGTA's September 2018 report on the BSA Program also recommended that the IRS coordinate with FinCEN on the authority to assert Title 31 penalties or reprioritize resources to more productive work. TIGTA's report found that the IRS spends considerable resources on the BSA Program; however, its impact on compliance is minimal. The IRS did not agree with the recommendation, stating that FinCEN intends to retain authority to impose Title 31 penalties to ensure consistent application across agencies. In January 2020, TIGTA officials met with FinCEN officials to discuss our finding in the September 2018 audit that the BSA Program has minimal impact on compliance and that its examiners are reluctant to refer cases for potential penalty issuance due to the perception of FinCEN inaction. As previously noted, the Acting Inspector General of the Treasury testified in 2004 that FinCEN was inconsistent and untimely in its enforcement actions and the IRS may be reluctant to refer future casino BSA violations, which was a finding on Title 31 penalty cases in our September 2018 report. We asked FinCEN officials to reconsider their decision not to allow the IRS to have penalty issuance authority; however, FinCEN officials declined to change the policy.

During this review, the Commissioner, SB/SE Division, confirmed that it would be beneficial for the IRS to have Title 31 penalty enforcement authority for BSA compliance purposes. In addition, the Commissioner stated that the IRS could increase Title 31 compliance if it had



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penalty authority and that he was scheduling time with FINCEN officials to discuss. However, he stated that, as with any new policy, it would take resources to set up a system to assess Title 31 penalties, evaluate options, develop a process, and implement.

Title 31 examination case files did not contain all required administrative elements

Our review of seven closed Title 31 examinations found three examinations that did not have documentation that the recommended group manager concurrence meeting was held within 30 calendar days after the initial appointment meeting. Examiners at the GS-12 level and below are required to use the concurrence meeting, while GS-13 examiners are encouraged to use the meeting to provide updates on examinations and obtain guidance from managers. These three examinations involved two GS-13 and one GS-12 examiners.

These meetings are an important step in case examination because it encourages discussion between the group manager and examiner about the case, such as discussing the initial appointment meeting, developing the plan for completing the case, and any other concerns. Not conducting a timely concurrence meeting may affect the efficiency and effectiveness of an examination because the manager and examiner may miss an opportunity for airing concerns or discussing plans and strategy.

Our review found that, in two of the seven examinations we reviewed, the examiner noted the issuance and receipt of Letter 1052, *Notification of Possible IRS Check to Verify Maintenance of Required Records and Filing Reports*, in the case file notes, but the file did not include a copy of the letter.⁴⁴ Letter 1052 is a notification letter used by SB/SE Division BSA examiners to notify Non-Bank Financial Institutions that they have BSA requirements. According to the IRM, a copy of Letter 1052 should be issued to newly identified entities and a copy retained in the administrative file.⁴⁵ Additionally, the BSA examiner must verify and document in the administrative file that the financial institution received the Letter 1052 when conducting a BSA examination.

We also identified one case file that did not contain all the indicated documentation in the case file. The case file notes and lead sheets referred to an existence of other third-party reports and referred to third-party workpapers, but the case file did not include those files. The IRM requires examiners to create a well-organized and professional case file.⁴⁶ A lack of organization and/or missing information in a case file may create confusion and difficulty for review of a case by others who have no direct knowledge of the case. Additionally, failure to include attachments in the case file may cause lack of assurance that the information is indeed present in the file.

Title 31 examiners did not generally identify income tax issues and refer examinations to Title 26 examination groups

Although BSA Program examiners generally pursue Title 31 issues, they are encouraged to make referrals to the BSA Examination Case Selection for Title 26 income tax examinations if they identify issues that indicate noncompliance. The IRM prohibits BSA Program examiners from requesting records during a BSA examination for any purpose other than for conducting the BSA examination. However, if information is discovered that may be considered for a possible income tax examination, the examiner should prepare Form 5346, *Examination Information*

⁴⁴ The current title of Letter 1052 is *Bank Secrecy Act Requirements Notification Letter* (June 2013).

⁴⁵ IRM 4.26.6.2.1(1) (Nov. 14, 2006), now replaced by IRM 4.26.6.3.1(1) (Oct. 8, 2019).

⁴⁶ IRM 4.26.6.4.9(1) (Nov. 14, 2006), now replaced by IRM 4.26.6.5.4 (Oct. 8, 2019).



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Report, to refer the issue for examination.⁴⁷ Some examples of transactions that may warrant submitting a Form 5346 are:

- Large cash deposits with inadequate records.
- The lack of cash deposits by a financial institution that usually generates large amounts of cash.
- Any other suspicious transaction that indicates the correct amount of income may not have been reported for Title 26 purposes.
- Potential structuring cases.

None of the examinations in our review had issues referred using a Form 5346. In a September 2018 report on the use of Currency Transaction Report information in examinations, TIGTA found that the IRS was not effectively tracking referrals from BSA Program examiners to the Examination function.⁴⁸ We recommended that the IRS establish formalized procedures for processing BSA Program referrals and begin formally tracking the time required to send referrals to the Field Examination Support team. The IRS agreed with the recommendation and, according to the IRS, implemented corrective action in November 2019. We found that the current training material provided to BSA Program examiners and frontline managers provides guidance to help assess whether an entity or its customers are potentially avoiding taxes and how to develop a referral without expanding the scope of the BSA examination into an income examination. The purpose of the BSA examination is not to identify information outside the scope of the BSA examination, but it is equally as important not to ignore transactions or activities that should be referred.

Recommendation 2: The Commissioner, Small Business/Self-Employed Division, should develop a process to use and monitor Title 31 virtual currency information in Title 26 examination workload.

Management's Response: The IRS agreed with this recommendation and stated that Interim Guidance Memo SBSE 04-0819-0021 provides guidance and references a monitored process for a Title 26 examiner to use FinCEN Query, which is Title 31 information. Additionally, the IRS stated that in July 2020 all FinCEN (Title 31) data were made available on its Compliance Data Warehouse, which is accessible to the Title 26 program.

⁴⁷ IRM 4.26.6.5 (2) and (3) (Nov. 14, 2006), now replaced by IRM 4.26.6.5.3.16(2) and (3) (Oct. 8, 2019).

⁴⁸ TIGTA Ref. No. 2018-30-076, *The Internal Revenue Service Still Does Not Make Effective Use of Currency Transaction Reports* (Sept. 2018).



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the IRS's efforts to ensure the accurate reporting of virtual currency transactions as required under U.S.C. Titles 26 and 31. To accomplish our objective, we:

- Determined the IRS policies and procedures in place to ensure tax compliance pertaining to virtual currency.
- Determined the effectiveness of the IRS's Title 26 virtual currency exchange audits (if any) and any efforts to ensure information reporting requirements by virtual currency exchanges.
- Determined the effectiveness and compliance impact of the IRS's Title 31 virtual currency exchange examinations process.
- Assessed information reporting compliance of virtual currency exchanges by analyzing volumes of Forms 1099-K issued by the exchanges.
- Evaluated the risk for fraud, waste, and abuse to obtain reasonable assurance that improprieties do not exist in the use of virtual currency exchange data within the LB&I and SB/SE Divisions.

Performance of This Review

This review was performed with information obtained from the IRS SB/SE Division headquarters located in Lanham, Maryland, and the LB&I Division headquarters located in Washington, D.C., during the period August 2018 through June 2020. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Major contributors to the report were Mathew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Linna Hung, Director; Curtis Kirschner, Acting Director; Glen Rhoades, Director; Robert Jenness, Audit Manager; and Sean Morgan, Senior Auditor.

Validity and Reliability of Data From Computer-Based Systems

We performed tests to assess the reliability of data from the IRS's Information Returns Master File and Audit Information Management System. We evaluated the data by (1) performing electronic testing of required data elements, (2) reviewing existing information about the data and the system that produced them, and (3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of this report.



The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the IRS's processes for planning and carrying out examinations on virtual currency exchanges. We tested these controls by performing analyses of individual tax return data from the Information Returns Master File located on the TIGTA Data Center Warehouse and examination status on the IRS's Audit Information Management System and reviewing and analyzing virtual currency examination case files.



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Appendix II

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 4, 2020

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Eric C. Hylton  Digitally signed by Gearl D. Harris
Date: 2020.09.04 15:10:59 -04'00'
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions (Audit #201830034)

Thank you for the opportunity to review and comment on the subject draft report. As reflected in your report, the Internal Revenue Service (IRS) has undertaken several measures to address virtual currency tax compliance risks. We continue to engage a broad spectrum of external stakeholders for feedback on how the IRS might balance taxpayer service with the proper regulatory enforcement of digital assets, including virtual currency.

The Department of the Treasury and IRS continue efforts to close the virtual currency information gap by working to develop guidance clarifying the proper information reporting required for these types of transactions. The Department of the Treasury 2019-2020 Priority Guidance Plan includes "Guidance regarding information reporting on virtual currency under §6045," which will address third-party reporting requirements under §6045 for brokers who effect sales of virtual currency. We intend to propose rules that avoid duplicate reporting under other information reporting regimes to the extent such brokers are also Third-Party Settlement Organizations (TPSOs).

As your report recognized, in 2018 the IRS' Large Business and International Division (LB&I) announced a virtual currency compliance campaign aimed at addressing virtual currency non-compliance through a range of actions including outreach, examination, and criminal prosecution. We issued more than 10,000 letters to taxpayers with virtual currency transactions to help them understand their tax and filing obligations and have initiated numerous examinations related to virtual currency non-compliance.

In Fiscal Year (FY) 2020, we identified and selected more than 4,000 cases between our Automated Underreporter Program and nonfilers sent to our Special Enforcement Program. We plan to identify additional virtual currency cases in FY 2021. The SB/SE Division's Bank Secrecy Act (BSA) program conducts an increasing number of Virtual



The Internal Revenue Service Can Improve Taxpayer Compliance for Virtual Currency Transactions

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Currency Exchange examinations each year. Although, the number of closures is relatively low, the closures do not account for the BSA program resources currently being expended to increase current and future coverage. The report suggests that an increase in Title 31 examinations of virtual currency exchanges could close the information reporting gap. However, BSA examiners are prohibited from accessing Title 26 information, which includes information return filings. Therefore, BSA examiners are prohibited from reviewing Title 26 information to identify virtual currency exchanges that are not complying with their Title 26 information reporting requirements.

Both in the subject report and in a report published in 2018¹, TIGTA has recommended that the IRS coordinate with FinCEN on the authority to assert Title 31 penalties. The report acknowledges, however, that FinCEN officials have declined previous attempts to change the policy on penalty issuance authority. Although we believe the IRS could increase Title 31 compliance with penalty issuance authority, significant resources would be necessary to build a penalty assessment framework. Additionally, FinCEN has numerous functional regulators who administer Title 31 enforcement activities, none of which have penalty authority. However, we have begun a dialogue with FinCEN to explore the possibility of obtaining penalty issuance authority and anticipate significant deliberation during the coming year.

Although this audit focused on work in our Examination organization, our work with virtual currency extends further. We are also adding an emerging mitigating threats team within the Office of Fraud Enforcement that will support our efforts on Cyber Currency tax fraud activities. The team will collaborate with other federal and state agencies and industry partners on emerging threats through informal discussions and interagency working groups. These interagency efforts can result in leveraging resources to maximize the outcomes to combat fraud. And for individuals and businesses with balances due, SB/SE Collection revised all Collection Information Statements (Forms 433) to include solicitation and documentation of information regarding virtual currency ownership.

In closing, we appreciate your continued input as we strive to support and improve taxpayer compliance for virtual currency transactions. Attached is a detailed response outlining our planned corrective actions. If you have any questions, please contact me or Scott Irick, Director of Examination, SB/SE Operating Division.

Attachment

¹ TIGTA, Ref. No. 2018-30-071, *The Internal Revenue Service's Bank Secrecy Act Program Has Minimal Impact on Compliance* (Sept. 2018).



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Attachment

RECOMMENDATION 1:

The Deputy Commissioner for Services and Enforcement should continue efforts to close the virtual currency information gap by issuing guidance clarifying the proper information reporting associated with virtual currency transactions.

CORRECTIVE ACTION:

The Treasury Department and the IRS are currently working to develop guidance on third-party reporting under §6045 of the Internal Revenue Code for certain taxable transactions involving virtual currency. The current Treasury and IRS Priority Guidance Plan identifies this guidance as a shared priority. Nonetheless, we are unable to guarantee an issuance date because the process by which guidance is developed is not within our sole control.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 2:

The Commissioner, Small Business/Self-Employed Division, should develop a process to use and monitor Title 31 virtual currency information in Title 26 examination workload.

CORRECTIVE ACTION:

Interim Guidance Memo SBSE 04-0819-0021 provides guidance and references a monitored process for a Title 26 examiner to use FinCEN Query, which is Title 31 information. Additionally, in July 2020 all FinCEN (Title 31) data is now available on the IRS's Compliance Data Warehouse (CDW) which is accessible, following protocols and internal controls, to the Title 26 program.

IMPLEMENTATION DATE:

Implemented

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A



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Appendix III

Abbreviations

BSA	Bank Secrecy Act
FinCEN	Financial Crimes Enforcement Network
FY	Fiscal Year
GAO	Government Accountability Office
GS	General Schedule
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business and International
MSB	Money Service Business
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration
TPSO	Third-Party Settlement Organization
TY	Tax Year
U.S.C.	United States Code