

CRYPTOCURRENCY CASE LAW: What Accountants Need to Know

By Eric P. Rothenberg, Esq. 



For many years now, I've written articles and spoken on cryptocurrency taxation to lawyers and accountants¹. The first case, "Kraken I"², was decided August 8, 2022, and the second case, "Kraken II"³ was just decided on June 30, 2023. While Kraken II is really all about each side (the IRS and Kraken) arguing what information must be provided to the IRS to comply with the summons, it also offers keen insight into the thinking behind IRS decisions and regulations.

The IRS filed *Kraken I* to enforce a summons against Ox Labs Inc. doing business as "SFOX". The IRS sought the account and transaction records from SFOX for the unknown names of their customers ("John Does"). The summons was limited, just as it was in the first case against Coinbase¹ [see FN 1]. The Treasury was seeking only those accounts (1) opened at SFOX; (2) by a U.S. taxpayer (3) who had at least \$20,000 in value of transactions and (4) only for the period starting 2016 and ending in 2021 (the "Summons Period"). These four requirements are called the "John Doe Class," and they are required to show it is an ascertainable class and that requirement was met with the limitations recited above. Because SFOX could readily deter-

mine which of its customers met the class limitations, the summons met the standards of third-party summons under IRC Section 7609 as well. Thus, the first element of allowing the summons was met.

The second element needed was to show there is a reasonable basis for believing the John Doe Class failed to comply with the Internal Revenue Laws. The IRS conducted an investigation and found 10 specific individuals who were customers at SFOX who failed to comply with U.S. tax laws. The bar for success by the IRS is low for a John Doe summons. To meet the "reasonable basis" prong in IRC Section 7609(f)(2), the government only needs to show that a transaction has occurred which is "of

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1) Scroll down to published works at <https://www.oarlawyers.com/eric-p-rothenberg/>

2) In Re Does, No. 21-CV-02201-JCS, 2021 WL 1222862, at *1 (N.D. Cal. Mar. 31, 2021)

3) United States of America, Plaintiff v. Payward Ventures, Inc., Defendant, U.S. District Court, N.D. California, 2023-2 U.S.T.C. ¶150,198, (Jun. 30, 2023)



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such a nature as to be reasonably suggestive of the possibility that the correct tax liability with respect to that transaction may not have been reported.” Because the summons was narrow and not requesting information available elsewhere, the court allowed the request.

Kraken II is case in which the defendant (Payward Ventures, Inc. D/B/A “Kraken”), refused to honor a summons by the IRS for information to see if their customers were complying with tax laws. The importance of *Kraken II* is not only its decision, but also because it contains information on how exchanges work.

Some facts I learned from *Kraken II*:

1 While Kraken is a cryptocurrency exchange offering the same services as nearly all its competitors, Kraken offered many account levels and services and the type of information the users must provide differs depending upon the type of account being opened.

2 To open an account, a user must choose among the different levels, and because some levels offer limited services, the user provides lower levels of verification. All levels had to provide basic information, but for the Intermediate and Pro accounts, confirmation was required by a driver’s license, passport and proof of residence. Pro account holders needed to complete a know-your-customer questionnaire including sources of income, intended use of the account and occupation. Only a Pro Account

could be an entity, but none of the accounts had any restrictions on the trading volume or dollar amount in value.

3 The accounts below Pro could also do margin trading of cryptocurrency, with some limitations. They also could “earn” extra cryptocurrency by running or maintaining the Blockchain [i.e., staking].

4 In *Kraken I*, for the summons to overcome a challenge, it had to show that a transaction occurred which is “of such a nature as to be reasonably suggestive of the possibility that the correct tax liability with respect to that transaction may not have been reported.” In *Kraken II*, a study done in 2016⁴ showed that the overall underreporting by third parties such as Coinbase, SFOX and similar exchanges was 55%, compared to just 5% for other 1099 type reporting where there is no requirement of withholding.

The IRS testified that in 2013-2015 only 800-900 taxpayers filed tax returns with a property description related to “bitcoin” or “virtual currency” even though Coinbase handled 5.9 million customers and handled more than \$6 billion in transactions during the Summons Period. Further the number of customers reporting cryptocurrency transactions on tax returns rose from 4,164 in 2016 to 842,888 in 2021.

The IRS, in response to concerns of cryptocurrency non-compliance, expanded its Electronic Payment Systems Initiative (EPSI), which began in 2005, to look for funds moving offshore and coming back. The initiative included creating a Virtual Currency Issue Team (VCIT) to study the compliance issues related to reporting of virtual currency transactions.

The *Coinbase* case (2017), permitted

4) Id. at page 3.



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the IRS to summons them for U.S. taxpayer transactions. Coinbase provided 13,000 customers to the IRS in response to the summons, of which 750 taxpayers with more than \$100 million in transactions have not been located (largely due to not having identification numbers).

The court commented in *Kraken II* that both sides made misstatements in reciting *Coinbase*. Neither side agreed on the definitions of “user” and Kraken did not want to produce information on those users that merely put money in, bought currency, held it and thus had no taxable event. The IRS argued that even just a deposit could be taxable income if it was compensation or another taxable event. The court rejected that as vague speculation and that argument did not prevail.

The *Kraken II* case is long and complex, and changed over time as the IRS and Kraken negotiated acceptable requests. The narrowed summons, recited in *Kraken II* [Case Footnote 7], requests considerable information, far beyond that of *Coinbase*, as the IRS became well versed in the world of cryptocurrency. Kraken requested this [those in *italics* were granted by the court]:

1. Account user registration records for each account owned or controlled by the user including:


- a. User profile, user preferences or account application information, regardless of how it is labelled or maintained, as follows: name, date of birth, taxpayer ID, physical address, telephone number, email
- b. History of all changes to the personal information since opened
- c. Complete user history for internet protocol addresses used to access the account
- d. Complete user payment methods regardless of date

2. With respect to any know-your-customer questionnaires from a user, information relating to employment, net worth and source of wealth for individual users, and for business users, legal name, address, country, website, contact information, industry, goods and services, government issued business registration or ID number and source of funds

3. All exception reports produced by your anti-money laundering (‘AML’) system, and all records of investigation of such exceptions – this does not include any suspicious activity reports (‘SAR’)

4. All records of activity in the user’s account including, but not limited to:

- e. Records identifying the date and time, amount and of any purchase or sale of cryptocurrency for U.S. dollar or foreign legal tender or other cryptocurrency
- f. Records identifying the date and time, value (or expense) of any




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lending, borrowing or margin position in the account

g. Records identifying the date and time, amount, U.S. dollar value, transaction hash (ID) and blockchain addresses for cryptocurrency unit transferred into or out of the user's account from another Kraken user or from outside of Kraken

h. Records identifying the date and time, amount and value of any units of cryptocurrency received by the user in the account as a result of a chain splitting event, such as a hard fork or promotional event

5. All records of deposits, withdrawals or transfers in U.S. or foreign legal tender, including transactions conducted through ACH transfers, wire or other electronic transfer, any and all invoices, billing statements, receipts or other documents

memorializing and describing such transactions

The court found as follows:

1 The court only permitted the IRS to request the information in 1(a) and as to the rest they could not show that it needs that information.

2 The court found it went beyond what is reasonably necessary.

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4 Based on the government's reply as to timing and documentation needed, it found most of Kraken's challenges to be moot.

5 The court found that apart from the definition of the term "user," Kraken doesn't dispute that request, but the court restricted the response to the extent it sought

records that go beyond Kraken's ledgers.

Kraken I and *Kraken II* are important cases concerning exchanges such as Coinbase, SFOX and Kraken. These will not be the last cases, and it is expected that there will be fallout from the IRS's VCIT and audits as a result of late reporting. ♦

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