

The tax man is back: IRS issues first John Doe summons in 2022 to major crypto platform, seeking treasure trove of information on tax noncompliance

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Key Takeaways:

- The IRS issued its fourth John Doe summons against digital asset platform sFOX, seeking information regarding user identity and transaction activity over \$20,000.
- The use of John Doe summonses likely will continue, as they are a powerful tool in the IRS' aggressive pursuit of underreporting in the digital asset space, which has led to the imposition of millions in tax assessments.

Recent announcements also have made clear that the IRS, along with the Department of Justice, is working with agencies such as the Joint Chiefs of Global Tax Enforcement and other state and federal agencies to curb the abuse of laws using cryptocurrency transactions.

After going for more than a year without using one of its most powerful weapons, a John Doe summons, the Internal Revenue Service (IRS) has reverted to the use of this tool in its much-publicized efforts to investigate, find, and prosecute those who fail to report virtual currency transactions and those who facilitate not reporting.

This latest filing demonstrates that Operation Hidden Treasure, announced in May 2021 to identify tax evasion among cryptocurrency users, is still going strong. Recent announcements also have made clear that the IRS, along with the Department of Justice (DOJ), is working with other agencies such as the Joint Chiefs

of Global Tax Enforcement and other state and federal agencies to curb the abuse of laws using cryptocurrency transactions.

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At the DOJ's request, a federal judge in California approved the service of a John Doe summons on cryptocurrency platform Ox Labs Inc., doing business as sFOX. The summons seeks information about its users' tax compliance.¹

According to the order, the IRS showed at least a “reasonable basis” that users of the platform “failed or may have failed” to comply with the internal revenue laws.² The order enables the IRS to seek user identity information and transaction activity for U.S. taxpayers who conducted at least \$20,000 in crypto-related transactions with or through sFOX between 2016 and 2021.³

Similar to prior IRS John Doe summonses, this should provide the IRS with yet another treasure trove of information, as the petition reports that sFOX has over 175,000 users, who have engaged in \$12 billion in transactions since 2015.

Citing the “pseudo-anonymous” nature of virtual currency transactions, the IRS and the DOJ presented the difficulties they face in enforcing instances of underreporting without the use of these summonses, bolstering their petition with 10 specific examples of taxpayers underreporting income.⁴

The IRS argued that the lack of direct reporting by third-party digital asset platforms to the IRS handicaps the IRS' ability to correlate individual taxpayers returns with the actual transactions

with which a taxpayer is involved. Bolstering the IRS' point, a recent Government Accounting Office study found that taxpayers misreport more than half of their income when there is limited or no third-party reporting.⁵

This John Doe summons is the fourth of its kind issued to digital asset platforms and seeking to identify taxpayers who fail to report tax effects of virtual currency transactions. In other cases, the IRS began reaching out to taxpayers regarding reporting requirements, conducting examinations, and making referrals to the Criminal Investigation Division after the digital asset platform complied with the summons and produced requested information.

The explicit reporting requirements as well as the IRS Commissioner's view that John Doe summonses are a "highly valuable enforcement tool that the government will use again and again to catch tax cheats" are unmistakable signs that John Doe summonses are here to stay.

To date, the IRS has sent 10,000 letters to taxpayers, advising them to pay back taxes and file amended returns, which has resulted in more than \$17.6 million in assessments. The IRS also subsequently opened audits of taxpayers identified by materials it has received, resulting in over \$92 million in total assessments.⁶

The IRS and the DOJ continue to aggressively pursue underreporting issues relating to digital assets. The IRS first ramped up its efforts with changes to Form 1040, showcasing the question "At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?" on the very first page of the form.⁷

Come next filing season, taxpayers also will be expected to specify whether they received any virtual currencies as a "reward, award, or compensation."⁸ According to Deputy Assistant Attorney General David A. Hubbert, "taxpayers who transact with cryptocurrency should understand that income and gains from cryptocurrency are taxable," making it clear that the IRS expects taxpayers to be aware of and heed their obligations or else face enforcement action.

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More recently, the passage of the Inflation Reduction Act will result in increased IRS funding in the amount of \$80 billion over 10 years, \$45.6 billion of which will be dedicated to tax enforcement, with digital asset monitoring and compliance activities named as priorities.¹⁰

The IRS noted in the petition that there is more to come, as another petition for a John Doe summons is being filed in the Southern District of New York against a New York bank, and it also made a point to discuss the more widespread issue of a lack of third-party information reporting by cryptocurrency platform companies, which necessitates these types of summonses.¹¹

This, combined with the front-and-center notice to taxpayers to report virtual currency transactions on their 1040s as well as other robust cross-agency enforcement efforts in the space and increased funding levels, should indicate that these summonses are very likely to continue to be served.

Further, once that information is handed over to the IRS from the company receiving the summons, individuals who have not reported their transactions should expect to hear from the IRS, have to pay back any owed taxes and potentially also face criminal liability.

Notes

¹ *United States v. John Does*, No. 22-cv-5715, order issued (C.D. Cal. Aug. 15, 2022). Order Granting Ex Parte Petition for Leave to Serve "John Doe" Summons, In the Matter of Tax Liabilities of John Does, Case No. 2:22-cv-05715-ODW-KS (Aug. 15, 2022).

² *Id.*

³ Press Release, "Court Authorizes Service of John Doe Summons Seeking Identities of U.S. Taxpayers Who Have Used Cryptocurrency," Dep't of Just. (Aug. 16, 2022), available at <https://bit.ly/3exkkc3>.

⁴ *Id.*

⁵ Report, "Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance," U.S. Gov't Accountability Office (Feb. 2020), available at <https://bit.ly/3cX07fh>.

⁶ *United States v. John Does*, No. 22-cv-5715, petition filed (C.D. Cal. Aug. 8, 2022). United States' Memorandum in Support of Ex Parte Petition for Leave to Serve "John Doe" Summons, In the Matter of Tax Liabilities of John Does (Aug. 8, 2022).

⁷ IRS, Form 1040, available at <https://bit.ly/3TQCUMA>.

⁸ Adam Hardy, "The IRS Wants to Change the Crypto Question on Tax Returns (Again)," News & Observer (Aug. 4, 2022), available at <https://bit.ly/3cPxmRP>.

⁹ "Court Authorizes Service of John Doe Summons," *supra* note 3.

¹⁰ See Inflation Reduction Act, H.R. 5376, § 10301.

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