

Takeaways From The IRS' Crypto Doc Summons Win

By **Carlos Ortiz, Kayley Sullivan and Jessica Mingrino** (November 1, 2024)

Those who thought their cryptocurrency transactions would remain anonymous or a secret from the Internal Revenue Service should think again.

Nearly 50 years ago, the U.S. Supreme Court held that information customers voluntarily provide to banks is not subject to Fourth Amendment privacy protections, and therefore can be disclosed to law enforcement. In September, in *James Harper v. Daniel Werfel*, the U.S. Court of Appeals for the First Circuit expanded this principle to cryptocurrency exchanges.

This ruling, as well as those of various district courts, confirms the ability of the IRS to identify taxpayers engaged in financial transactions involving cryptocurrency exchanges. Much as for taxpayers decades ago who believed their use of Swiss bank accounts would allow them to conceal their income, this ruling is another wake-up call for any who may still have similar thoughts about using digital asset currency exchanges.

The issuance of John Doe summonses remains one of the strongest tools in the IRS' enforcement arsenal. A John Doe summons is an investigative tool used by the IRS to seek information about unnamed taxpayers from a third party, thereby enabling the IRS to gather the information necessary to determine the identity of individuals it believes may be violating tax laws.[1]

These summonses also allow the IRS to obtain information on large numbers of taxpayers in one fell swoop. In recent years, the IRS has issued such summonses to major cryptocurrency exchanges, such as Coinbase, Kraken and Circle Financial, seeking taxpayer information.

The First Circuit's September decision in *Harper* upheld the IRS' right to issue John Doe summonses to cryptocurrency exchanges, finding that cryptocurrency users do not have a Fourth Amendment reasonable expectation of privacy in their records held by exchanges.[2]

This decision effectively gives the IRS Criminal Investigation division, or IRS-CI, the green light to continue using these summonses to gather information.

While the use of John Doe summonses isn't new — the IRS-CI has been using them for years — this is the first time a court of appeals has expressly approved their use. For years, federal prosecutors have been champing at the bit by ramping up investigations of and enforcement against taxpayers who use digital assets to evade tax liabilities.

Harper should serve as a signal to taxpayers and cryptocurrency exchanges alike that the IRS-CI will not be letting up anytime soon.



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The Harper Case

In 2016, the IRS issued a John Doe summons to Coinbase, seeking information on all U.S. Coinbase account holders who engaged in cryptocurrency transactions between 2013 and 2015. Coinbase challenged the breadth of the request, and the IRS subsequently tailored the summons to capture only users who engaged in at least \$20,000 worth of transactions in a calendar year.

James Harper was one of those users. He received a letter from the IRS in 2019 — by which time he had already liquidated all of his bitcoin holdings or transferred them to a hardware wallet — notifying him that the IRS had information that indicated he had not accurately reported his virtual currency transactions.

Harper then filed a complaint in the U.S. District Court for the District of New Hampshire alleging, among other things, that the John Doe summons the IRS used to ascertain his identity and personal information was in violation of his Fourth Amendment rights.

The district court dismissed Harper's complaint, finding that he lacked the required reasonable expectation of privacy in the information he voluntarily shared with Coinbase. The First Circuit agreed.

In upholding the district court, the First Circuit relied heavily on the 1976 Supreme Court case *U.S. v. Miller*.^[3] There, the court held that the government was legally permitted to obtain customer information that had been voluntarily provided without being in violation of the Fourth Amendment.

The Harper court analogized Harper's Coinbase records to the bank statements in *Miller*. Furthermore, Judge Kermit Lipez emphasized that Coinbase's own terms of service explicitly warn customers of the possibility that their information could be disclosed to law enforcement.

Ultimately, the First Circuit was unpersuaded that cryptocurrency exchange records are significantly different from traditional bank records.

What Harper Means for Taxpayers

Taxpayers should take care to ensure that all gains and losses are diligently reported on their tax returns, including those from digital asset transactions. They should be operating under the assumption that the IRS has or can obtain information that will reveal any transactions that took place and the resulting gains or losses.

Those who have failed to accurately report past transactions should determine their best course of action, which may include self-reporting the tax noncompliance or potential noncompliance.

Further, taxpayers should be clear that the perceived anonymity associated with blockchain technology will not prevent the IRS-CI from obtaining information related to their cryptocurrency activities. Simply put, certain sales and exchanges of cryptocurrency are taxable transactions, and taxpayer attempts to evade any tax that may result from them are becoming increasingly easy for the IRS-CI to identify.

It's likely that John Doe summonses will lead to large-scale audits of individual taxpayers, resulting in potential civil penalties and criminal prosecution for taxpayers discovered to have willfully failed to report tax owed, thinking their transactions would remain secret.

For the past four years, taxpayers have had to certify on their Form 1040 whether they had engaged in any cryptocurrency transaction. If the government obtains transaction records showing that an individual engaged in cryptocurrency transactions, but certified otherwise on their 1040, the IRS will easily be able to identify those discrepancies and take action that includes a potential criminal prosecution for willfully filing a false tax return.

What Harper Means for Cryptocurrency Exchanges and Their Attorneys

Cryptocurrency exchanges should regard Harper as a warning that courts may continue to analogize the information customers provide them to the information provided to traditional banks.

In the wake of this ruling, exchanges should expect the IRS to continue utilizing this method of obtaining user information to identify taxpayers who have not reported gains from virtual currency transactions.

Exchanges should ensure they are providing disclaimers to customers that their information may be disclosed to law enforcement and should reexamine contracts with their users to ensure that they accurately reflect the current legal landscape. Indeed, one of Harper's arguments was that he had entered into a contract with Coinbase pursuant to which Coinbase agreed to maintain the privacy of his personal information.

Exchanges, though, should also exercise caution to avoid being perceived by the IRS as providing a means for taxpayers to conceal their transactions, or as warning taxpayers not to use their services because of the risk that information may be disclosed to law enforcement.

Exchanges that receive a John Doe summons should take care to determine the most appropriate way to respond, balancing their ethical and legal duties, the fiduciary duty owed to their clients, and the business considerations for the company.

Harper is also important for traditional banks, which may also be subject to John Doe summonses. The IRS has already issued one such summons, in 2022, to M.Y. Safra Bank to obtain information regarding customers of a cryptocurrency exchange, SFOX, which had used M.Y. Safra's banking services.

Banks that engage in business with cryptocurrency exchanges or other users of virtual currency must ensure that their contracts and compliance programs are up to date in addressing these risks.

Further, cryptocurrency exchanges should maintain reliable recordkeeping systems in accordance with any applicable retention period laws. The IRS-CI's ability to obtain information about customer transactions is likely to alert the IRS of any suspicious customer activity, and both exchanges and traditional banks risk putting themselves under the microscope if suspicious activity that should have been caught is uncovered by them.

Conclusion

The IRS and the U.S. Department of Justice have historically made no secret of their willingness to prosecute companies and individuals that assist or facilitate taxpayers in evading their obligations, whether they are located in the U.S. or offshore.

Now more than ever, it is imperative that companies and individuals take steps to comply with all applicable laws and regulations. It is clear that enforcement will continue to increase in volume, that the consequences of noncompliance and underreporting will increase in severity, and that the breadth of IRS investigations will expand as agents are trained to target digital assets efficiently and effectively.

Now is the time for taxpayers and other entities in this industry to address any issues they may have, as the courts just made it that much easier for the tax man to find them.

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[1] See IRM 25.5.7 (June 4, 2020).

[2] Harper v. Werfel, No. 23-1565, 2024 WL 4274110 (1st Cir. Sept. 24, 2024).

[3] U.S. v. Miller, 425 U.S. 435 (1976).