

DIGITAL ASSETS: Watchdog Urges IRS to Ramp Up Enforcement Efforts Significantly

by Steven Toscher and Philipp Behrendt

I. Introduction

In the ever-evolving financial technology landscape, virtual currencies, now more broadly termed "digital assets," have emerged as a significant challenge for tax administration. The Treasury Inspector General for Tax Administration (TIGTA) recently released a comprehensive report titled "Virtual Currency Tax Compliance Enforcement Can Be Improved" ([Report Number: 2024-300-030, dated July 10, 2024](#)). This report provides a critical examination of the Internal Revenue Service's efforts to address tax compliance in the realm of digital assets. As tax professionals, it is incumbent upon us to thoroughly understand and analyze these findings to better serve our clients and navigate the complex intersection of tax law and emerging financial technologies.

The findings are that Criminal Investigations ("CI") "has taken advantage of analytic tools to address virtual currency noncompliance. The efforts of IRS civil enforcement components (LB&I, SB/SE, and AUR) "are primarily indirect and negligible" and "do not use taxpayers' responses" to digital asset questions on Form 1040 to identify potential underreporting effectively. The TIGTA report makes three recommendations for improving the IRS' digital asset enforcement efforts. IRS management agrees with all three recommendations.

A. The Growing Digital Asset Landscape

The TIGTA report begins by highlighting the explosive growth in the digital asset market, providing context for the challenges facing the IRS. In April 2020, there were approximately 5,000 types of virtual currencies in existence. By July 2023, this number had skyrocketed to over 26,000, representing a staggering 420% increase in just over three years (p. 2). This rapid proliferation of digital assets underscores the dynamic nature of the market and the difficulties faced by regulatory bodies in keeping pace.

To further illustrate the scale of this market, the report notes that as of June 11, 2024, the two dominant virtual currencies, Bitcoin and Ether, had a combined market value exceeding \$1.7 trillion and account for 82% of virtual currency market values (p. 2). This figure alone demonstrates the significant economic impact of digital assets and the potential tax implications of transactions involving these currencies.

B. IRS Enforcement Efforts: A Tale of Two Approaches

The TIGTA report presents a stark contrast between the IRS's criminal and civil enforcement efforts in the digital asset space. This dichotomy highlights both the potential for effective enforcement and the significant challenges that remain in ensuring comprehensive tax compliance.

i. Criminal Investigation: A Success Story

The report commends the efforts of CI in addressing virtual currency noncompliance. From Fiscal Years 2018 to 2023, CI investigated 390 cases involving digital assets, with 224 of these cases completed with a recommendation for prosecution. This high rate of prosecution

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Total cases investigated: 390
Cases completed with prosecution recommendation: 224*

recommendations suggests that CI is focusing on high-impact cases with strong evidence of criminal activity.

CI's success can be attributed, in part, to its effective leveraging of analytics tools to address virtual currency noncompliance. CI has been using data analytics tools since 2014 to identify potential fraud involving digital assets. One such tool analyzes blockchain public ledger data to track digital assets. Although no specific tool is named, this is likely a reference to the Chainalysis Reactor. This use of advanced technology demonstrates CI's adaptability in the face of evolving financial crimes. It suggests that with the right tools and approach, the IRS can effectively tackle the challenges posed by the pseudonymous nature of many digital asset transactions.

While the total number of cases does not seem much, in a time of plummeting prosecution of tax crime cases this number is not insignificant. CI's annual reports show that around 2,660 criminal investigations were initiated, and 1,900 prosecutions were recommended each year in the period 2021-2023.¹ While total investigations and prosecutions remained stable, investigations and

*From 2018 to 2023, Cases with digital assets and
cases recommended for prosecution have more than
doubled.*

recommended prosecutions of digital asset cases more than doubled from 2018 to 2023.

¹ See <https://www.irs.gov/pub/irs-pdf/p3583.pdf>, p. 66.

The dollar value of seizures in cases involving digital assets ballooned. During FYs 2018 through 2022, the value of seizures increased from approximately \$1.5 million to about \$7 billion (p. 10).

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The report says that in fiscal 2021, 2022, and 2023, 354 digital assets led to CI originated from the Research, Applied Analytics and Statistics Division (RAAS). TIGTA reports that “RAAS performs its own research to detect specific characteristics associated with digital asset transactions as part of its ongoing projects to identify taxpayer noncompliance”. In 2023 alone, RAAS sent 205 leads to IRS CI, showing its exponential importance in the digital asset area.

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One problem TIGTA highlighted was that when CI rejects a RAAS lead, RAAS does not send the information to the IRS’s civil compliance components. TIGTA recommends that CI send rejected leads to civil compliance.

TIGTA highlights the importance of technological adaptation, specialized training, and focused resources in addressing noncompliance in this complex field.

C. Civil Examination: Room for Improvement

In contrast to the success of criminal enforcement efforts, the report criticizes the IRS's civil examination efforts related to digital assets. These efforts are described as "mostly indirect and negligible" (p. 9), indicating a significant gap in the IRS's overall enforcement strategy.

i. Form 1040 Digital Assets Question

One of the missed opportunities identified in the report is the IRS's failure to effectively utilize responses to the digital assets question on Form 1040 for compliance activities. Since Tax Year 2020, this question has occupied a prominent position on the first page of Form 1040, asking taxpayers if they have engaged in any digital asset transactions during the tax year.

The potential of this question as a compliance tool is significant. It could serve as an initial filter to identify taxpayers engaged in digital asset transactions, allowing for more targeted audits and compliance checks. However, the report indicates that the IRS is not leveraging this information for case selection or other compliance activities. This represents a squandered opportunity to enhance voluntary compliance and identify potential areas of noncompliance.

TIGTA urges IRS to utilize the digital asset question on the tax return more effectively.

The TIGTA report names how the different IRS civil divisions and units use the data from the digital asset question but in the released reports, the relevant parts are redacted (p. 13). “LB&I Division combines the Form 1040 virtual question response data with other data points to identify high-risk compliance taxpayers” (p. 13), and it appears that LB&I assigns a higher compliance risk if this question is answered incorrectly. The SB/SE Division uses the responses to generate information for a database and the information is used with other data during taxpayer examinations. SB/SE’s Automated Underreporter (AUR) unit appears to have trouble identifying matching data, probably because without comprehensive information reporting, there is no data to match.

ii. Operation Hidden Treasure

The report sheds light on how successful "Operation Hidden Treasure" was an initiative described as a partnership between the IRS's criminal and civil functions to identify taxpayers omitting digital assets from their tax returns. Despite its promising premise, the operation has largely been limited to the acquisition of tools and training for employees, rather than the active pursuit of noncompliant taxpayers.

This initiative provided over 600 licenses for blockchain analysis tools to IRS employees of the SB/SE Division’s Office of Fraud Enforcement to identify unlawful activities. However, no written accounts were available on the results or effectiveness of this compliance initiative.

iii. John Doe Summonses

The TIGTA report offers insight into the utilization of data obtained through John Doe Summonses. Since 2018, the IRS has summoned taxpayer information with specific account values from particular cryptocurrency exchanges. Unsurprisingly, this data was instrumental in identifying taxpayers with undisclosed cryptocurrency transactions. The report highlights that information from the John Doe Summons to Coinbase led to 216 taxpayers being placed under examination and nearly 15,000 taxpayers receiving a "soft letter," which requested them to come into

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compliance.

However, the redactions in this section are notable. The total number of John Doe Summonses issued is redacted, as is the text following the sentence: "The LB&I Division has additional John Doe Summonses in process." The IRS has to receive US District Court approval to serve a John Doe summons.² Public court filings reveal five John Doe Summonses.³

The TIGTA report also suggests that the practice of issuing John Doe Summonses may no longer be necessary, at least for exchanges that report via 1099-DA.

iv. Other Compliance activities

The TIGTA report points out that LB&I Division's Virtual Currency Campaign includes several compliance activities aimed at ensuring taxpayers meet their obligations regarding digital assets, and one of the campaigns is targeted towards non-compliance in the digital asset space.

In addition, the report names two more activities:

- Compliance Efforts from Spontaneous Information Exchanges: These efforts include letters and audits initiated based on information spontaneously exchanged from other jurisdictions. This information, typically uncovered during tax examinations, investigations, or other administrative procedures, indicates potential noncompliance with tax laws and proves useful to foreign partners for tax purposes.

² See IRC Sec. 7609(f), IRM 25.5.7.1.3 (06-04-2020).

³ Coinbase, authorized by the court on 11/30/2016; Circle/Poloniex (4/1/2021); Kraken (5/5/2021); SFOX (8/15/2022); and M.Y. Safra Bank for cash deposit accounts for SFOX users (9/22/2022).

- Participation in International Forums: The LB&I Division participates in two international forums through the Joint International Taskforce on Shared Intelligence and Cooperation and the Organization of Economic Cooperation and Development.

Parallel to the LB&I Division's efforts, the SB/SE Division's Examination in December 2022 launched a Compliance Initiative Project (CIP) focused on digital assets. The project's goal is to evaluate leads and referrals involving digital assets from CI and IRS's Bank Secrecy Act examiners. This initiative is scheduled to conclude in February 2025. As of June 2023, the CIP included 48 cases, but no measurable results were available as none of the examinations had been closed.

In addition to the CIP, the SB/SE Division also handles cases arising from the 2018 John Doe Summons, routine examinations, and other sources of information that may involve digital assets.

Between FY 2020 and May 2023, the division conducted 1,144 examinations of taxpayer returns that included digital asset activities, a small fraction (0.31 percent) of the 365,391 total examinations. However, the tax assessments from these examinations rose significantly, from \$507,850 in FY 2020 to over \$12.2 million by May 2023. Notably, about half of the returns examined during this period showed average assessments nearing \$55,000, indicating the potential for uncovering significant underreporting of digital asset activity if examinations were conducted on a larger scale.

Fiscal Year	Total Number of Returns Examined	Number of Returns Examined That Had a Digital Asset Component	Number of Returns Examined With a Digital Asset Component With Tax Assessed	Total Tax Assessed on Those Returns With a Digital Asset Component	Average Assessment Amount
2020	101,371	27	16	\$507,850	\$31,741
2021	108,660	241	120	\$3,904,431	\$32,537
2022	98,682	486	267	\$13,187,349	\$49,391
2023	56,678	390	224	\$12,258,798	\$54,727
Totals	365,391	1,144	627	\$29,858,428	\$168,396

Source: TIGTA's review of SB/SE Division examinations (as of May 2023).

This demonstrates why TIGTA believes that more examinations are required and promise a significant amount of additional tax revenue if these examinations are rolled out on a larger scale.

v. Automated Underrepoter Program (AUR)

The SB/SE Division's AUR Program regularly matches information return data with tax return information to detect noncompliance and propose assessments. Although the AUR cannot yet integrate digital asset characteristics to detect noncompliance, it uses case selection criteria to identify discrepancies in Form 1099-K and Form 1099-MISC filing data for further screening. From tax years 2018 through 2020, the AUR screened over 7,000 returns associated with digital asset activities out of nearly 5.8 million returns reviewed.

TY	Total Returns Reviewed	Returns Reviewed With a Digital Asset Component				
		Cases Completed	Cases With Tax Assessed	Tax Assessed Percentage of Returns Reviewed	Total Tax Assessment Dollars on Reviewed Returns	Average Assessment Per Case With Tax Assessed
2018	2,489,165	3,791	1,285	34%	\$150,190,871	\$116,880
2019	1,955,681	1,384	468	34%	\$40,674,933	\$86,912
2020	1,312,081	1,895	948	50%	\$27,332,426	\$28,832
Totals	5,756,927	7,070	2,701	38%	\$218,198,230	\$232,624

Source: TIGTA's review of AUR cases (as of March 2023).

As of March 2023, the AUR's review of TY 2020 returns with digital asset components resulted in the closure of 1,315 of the 1,895 returns reviewed. Among these, 948 cases led to total tax assessments exceeding \$27.3 million, with an average assessment of \$28,832. Despite digital assets comprising a small percentage of all AUR cases in past years, the report demonstrates that there is significant untapped potential for addressing digital assets compliance on a larger scale.

CI and IRS civil compliance components are awaiting the final digital asset broker reporting regulations and the introduction of Form 1099-DA. Currently, CI agents spend substantial time and effort linking digital asset transactions to specific taxpayers. When Form 1099-DA comes into use, the data will allow CI to operate more efficiently.

The combination of the Automated Underreporter Program (AUR) and future broker reporting (Form 1099-DA) will uncover non-compliance on a larger scale but poses a risk for the unwary due to the potential for incomplete or incorrect 1099-DAs.

Form 1099-DA will allow the AUR to identify digital asset reporting discrepancies by matching the information form with taxpayer returns. The AUS "plan to build cases based on the discrepancies identified."

Form 1099-DA will assist revenue agents from the LB&I and SB/SE Divisions by providing third-party information documents necessary for income probes during examinations. Form 1099-DA will enhance the efficiency of determining whether taxpayers have correctly reported income from digital asset transactions, as it will include gross proceeds from such transactions.

Note: The introduction of Form 1099-DA and the AUR's numbers carry a risk for the unwary. These 1099-DAs may not be as accurate as the IRS and TIGTA would hope. Brokers that are required to report transactions occurring on or after January 1, 2025, may not have the information needed to distinguish between taxable and non-taxable transactions and, they may

report incorrect or incomplete basis information. Taxpayers are strongly advised not to ignore incorrect 1099-DAs but to address any discrepancies promptly. Reacting early to incorrect forms is crucial to prevent potential issues with tax compliance and avoid unnecessary complications with the IRS. The AUR is an automated matching program that does not depend on manpower the IRS might otherwise lack to examine all taxpayers, eliminating chances for playing the audit lottery.

vi. Information Reporting Delay

Perhaps the most significant challenge highlighted in the report is the delay in implementing new information reporting requirements for digital asset transactions. The Infrastructure Investment and Jobs Act (IIJA) of November 2021 requires brokers to file information returns for digital asset transactions. In response, the IRS created Form 1099-DA (Digital Assets) to capture this information (p. 9).

However, while the IIJA was effective for transactions after January 1, 2023, proposed regulations delay implementation as follows:

- Gross proceeds reporting: January 1, 2025
- Basis reporting: January 1, 2026.

As tax professionals, we must prepare our clients for the eventual implementation of these reporting requirements while navigating the current landscape of limited information reporting. The TIGTA report sees Form 1099-DA as an important tool to identify non-compliance. It states that during the period before the implementation of the Form 1099-DA reporting regime “the IRS should be preparing to launch a comprehensive digital asset compliance enforcement program while developing lines of sight into digital asset transactions” (p. 19).

vii. Recommendations

The TIGTA report contains three recommendations, all of which IRS management agrees. Two of the three recommendations and responses were redacted. They are:

Recommendation 1: The LB&I Division, SB/SE Division Examination, Criminal Investigation, RAAS, and the Digital Assets Initiative Project Office analyze

***** of digital assets.

Management’s Response: IRS management agreed that
***** with digital asset transactions. It will use ***** in the development of an IRS-wide Compliance Strategic Plan.

Recommendation 2: The LB&I Division, SB/SE Division Examination, RAAS, and the Digital Assets Initiative Project Office leverage data pertaining to ***** compliance activity.

Management's Response: IRS management agreed that tax return data should be used to ***** . It will ***** the development of an IRS-wide Compliance Strategic Plan.

Recommendation 3: The LB&I Division, SB/SE Division Examination, Criminal Investigation, RAAS, and the Digital Assets Initiative Project Office develop a compliance plan that includes the use of Form 1099-DA data, case identification, and case selection of digital asset cases.

Management's Response: IRS management agreed that Form 1099-DA data should be used to develop an IRS-wide Compliance Strategic Plan. It noted that the revision to I.R.C. § 6045 is not self-executing and that final regulations are required before the Form 1099-DA and the information required on the form can be finalized for filing with the IRS.

II. Looking Ahead: The Future of Digital Asset Tax Compliance

TIGTA is urging the IRS to strengthen its enforcement efforts in the area of digital assets because of the huge potential to uncover underreporting and non-compliance. It urges the IRS to utilize the digital asset question on the tax returns in connection with the Form 1099-DA reporting to identify taxpayers who have not fully reported their digital asset transactions.

As we consider the findings of the TIGTA report and their implications, it's important to look ahead and anticipate future developments in digital asset tax compliance beyond TIGTA's suggestions.

Given the global nature of digital assets, we can expect increased international coordination on tax compliance efforts. This may involve:

- Information sharing agreements between tax authorities of different countries;
- Standardization of reporting requirements across jurisdictions;
- Coordinated enforcement actions against international tax evasion schemes involving digital assets.

As blockchain technology continues to evolve, we can anticipate new challenges and opportunities in tax compliance. However, the IRS should be able to utilize tools it has licensed or will license in the future and tailor them to their needs. This might include:

- Development of "tax-aware" blockchain protocols that automate certain investigation and computation processes;
- Integration of tax reporting features into digital wallets and exchange platforms;
- Advanced analytics tools for tracking and analyzing on-chain transactions.

So, even though the total number of investigated and audited taxpayers appears low in the grand scheme of the use of digital assets by US citizens and nationals, the IRS will be enhancing its enforcement in this area. This report from the IRS's watchdog, TIGTA, will in all probability lead to Congress urging the IRS to use its additional funding to tap into this pot of additional tax revenue. Furthermore, Form 1099-DA reporting, international cooperation, and the development of additional technical tools will make it easier for the IRS to identify taxpayers the IRS can target.

III. Conclusion

The TIGTA report on virtual currency tax compliance enforcement serves as a crucial wake-up call for both the IRS and tax professionals. It highlights the significant challenges posed by the rapid growth of digital assets, while also pointing to potential solutions and areas for improvement.

As tax professionals, we play a vital role in bridging the gap between the evolving digital asset landscape and the slower pace of regulatory adaptation. By staying informed, embracing technological solutions, and taking a proactive approach to compliance, we can help our clients navigate this complex terrain while supporting the broader goal of fair and effective tax administration.

The coming years will undoubtedly bring further developments in digital asset regulation and tax enforcement.

By remaining vigilant, adaptable, and committed to ongoing education, we can position ourselves and our clients to meet these challenges head-on. Utilizing in part the same analytics tools and partners the IRS uses to address virtual currency noncompliance, we will be able to provide the best service to our clients. The future of tax practice will increasingly intersect with the world of digital assets, and those who are prepared will be best positioned to thrive in this new landscape.

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