

Tax Litigation Issues

Expert Analysis

Tax Enforcement, John Doe Summonses And Digital Currency

Over the past 10 years, the Internal Revenue Service has devoted substantial resources to its battle against bank secrecy and the use of offshore accounts to evade income taxes. Individuals bent on ensuring secrecy with respect to their financial dealings, however, have other tools available to them and the IRS is constantly identifying and attacking these new devices. With the advent of virtual currencies, the IRS faces a new threat that has the potential of rendering assets effectively untraceable. In tackling the challenge presented by 21st century transactions, the IRS has turned to “John Doe” summonses, a tried-and-true method that has been an integral part of its enforcement program for decades.

Pursuant to §§7602 and 7609 of the Internal Revenue Code, the IRS has the authority to issue—with court approval—John Doe summonses, which are addressed to

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third parties and seek information relating to unidentified persons. This past November, the IRS filed an ex parte petition for leave to serve a John Doe summons on Coinbase, a San Francisco-based

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virtual currency exchange, seeking identifying information and transaction records relating to its U.S. clients. On November 30, Magistrate Judge Jacqueline Scott Corley of the U.S. District Court for the Northern District of California granted the petition, but two weeks later, a Coinbase customer moved to intervene, arguing that the summons was overbroad, invasive, and unlikely to capture untaxed transactions. This dispute raises questions about whether technology

and privacy can ever outpace enforcement.

John Doe Summonses

When the IRS serves a summons on a third party seeking information relating to a specific taxpayer, that taxpayer is entitled to notice and can move to quash the summons. In the early 1970s, the IRS started using John Doe summonses to obtain information from third parties relating to an unidentified person or group. Given that John Doe summonses seek information relating to unknown persons, notice is not possible and thus only the third party who received the summons is in a position to challenge it.

In *United States v. Bisceglia*, 420 U.S. 141 (1975), the IRS had learned of an unusual bank deposit and issued a summons to the bank seeking the identity of the depositor. The bank refused to respond and, after the district court granted the IRS's petition to enforce the summons, the U.S. Court of Appeals for the Sixth Circuit reversed, concluding that §7602 does not authorize the IRS to issue summonses “enabling it to inquire into the financial affairs of a

group of unspecified persons in the hope of identifying” someone who has not complied with the Internal Revenue Code. *Bisceglia v. United States*, 486 F.2d 706, 712-13 (6th Cir. 1973). In reversing, the Supreme Court recognized the danger that summonses aimed at an unspecified person could be misused and give rise to “fishing expeditions,” but concluded “[t]hat the power may be abused is no ground for denying its existence.” 420 U.S. at 150.

In response to the Supreme Court’s decision in *Bisceglia*, in 1976 Congress added §7609(f), which requires the IRS to receive judicial approval before issuing John Doe summonses. As the Supreme Court later noted in *Tiffany Fine Arts v. United States*, 469 U.S. 310, 320 (1985), “the Court takes the place of the affected taxpayer ... and exerts a restraining influence on the IRS.”

Recent Practice

Under §7609(f), to obtain authorization to serve a John Doe summons, the IRS must demonstrate, generally through a Revenue Agent’s declaration, that (1) “the summons relates to the investigation of a particular person or ascertainable group or class of persons”; (2) it has “a reasonable basis for believing that such persons or group or class of persons may have failed to comply with” the Internal Revenue Code; and (3) the information being sought, including the identity of the person or persons suspected of having violated the Internal Revenue Code, is not readily

available from another source. The Internal Revenue Manual provides guidance regarding the evidence necessary to support an application for a John Doe summons and establishes multiple layers of internal review before an agent may seek judicial authorization.¹

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summonses are particularly effective in investigating non-compliance through actions that mask the taxpayer’s identity. Beginning with a 2002 summons served on VISA International seeking information regarding overseas credit and debit cards held by U.S. taxpayers,² the IRS has effectively used John Doe summonses to advance its efforts to combat offshore tax evasion. Thus, in 2008 the IRS served a John Doe summons on UBS, which was a lynchpin of the recent enforcement programs aimed at taxpayers with undisclosed offshore accounts. Since then, the IRS has issued at least 18 other John Doe

summonses to financial institutions around the world, including banks in Switzerland, Latin America, and the Caribbean, as well as couriers that are alleged to have been used by taxpayers to correspond with their offshore banks.³

Virtual Currencies

Prior to the mainstream popularization of Bitcoin in 2009, “virtual currencies” were most commonly associated with online black markets and exchanges of untraceable value. The growing virtual currency market has raised concerns for regulators: They are effectively decentralized, private markets, existing without oversight by any one institution. At least theoretically, this enables users to engage in transactions that are unmonitored by banks or law enforcement agencies.

In practice, however, most investors rely upon exchanges and virtual wallets to manage their digital holdings. As mentioned above, last November the IRS obtained authorization to serve a John Doe summons on virtual currency exchange Coinbase, which has more than 5.3 million users in 33 countries, accounting for \$5 billion in virtual transactions. The summons seeks customer data and transaction records for all U.S. clients during 2014 and 2015.⁴

In response to the summons, Jeffrey K. Berns, an attorney and Coinbase customer, moved to intervene and quash the summons on behalf of himself and other Coinbase

customers. In so doing, Berns sacrificed his own anonymity arguably to defend the broader privacy interests of other users of virtual currency.

In attacking the summons, Berns argued that the IRS had not made a sufficient showing that virtual currencies were used to evade income taxes, and that its attempt to get records of transactions by an estimated one million U.S. Coinbase customers over a two year period was tantamount to a “fishing expedition.” In making this argument, Berns noted both the breadth of the information sought and the IRS’s budget constraints, which would assumedly limit its ability to analyze the data it receives. Berns further complained that the summons sought personal and security information unrelated to tax compliance, and that given past security breaches, providing the data to the IRS would expose the identities and funds of Coinbase’s customers to hackers. Finally, relying on an Inspector General’s report criticizing the IRS’s guidance regarding the tax consequences of virtual currency transactions, Berns challenged the IRS’s claim that the summons was aimed at policing tax compliance.

The IRS responded principally by disputing Berns’s right to intervene. Specifically, the IRS argued that once it learned his identity, it had withdrawn the summons as to Berns, thereby mooting his motion to intervene. The IRS further argued that taxpayers affected by a John Doe summons are not entitled to

intervene, let alone move to quash the summons. Rather, the sufficiency of the IRS’s showing under §7609(f) is determined by the district court on an ex parte application, and the court’s review of its application operates as a substitute for the review that would take place on a motion to quash by an affected taxpayer. Finally, the IRS disputed Bern’s substantive claims regarding the propriety of the summons and its motives.⁵

Going Forward

Regardless of the outcome Berns’s motion, the arguments made with respect to the John Doe summons issued to Coinbase raise important considerations with respect to tax enforcement in a new era. First, while virtual currencies promise privacy, the reality is that investors are exposed to the same investigative techniques as taxpayers who sought to protect their anonymity through offshore bank accounts, and the IRS may well be able to reach records held by third parties upon which the vast majority of virtual investors must rely. Second, even if the court finds that Berns has standing to challenge the summons issued by Coinbase, taxpayers will either need to rely on the third parties to protect their interests or be prepared to forgo their anonymity in order to challenge a summons in court. Finally, while virtual currency users may argue that the IRS has not provided guidance with respect to the tax consequences of their conduct,

the Coinbase summons should be a wake-up call for those virtual currency users who have assumed that their transactions will escape detection. It should be clear that the IRS will aggressively pursue tax avoidance in the virtual sphere, and John Doe summonses will continue to provide the IRS with a powerful investigative tool in this arena.



1. Internal Revenue Manual §25.5.7.3 (Procedures), §25.5.7.5.2 (Reasonable Basis).

2. See, e.g., Press Release, U.S. Department of Justice (March 25, 2002), available at https://www.justice.gov/archive/tax/usaopress/2002/txdv022002_03_25_visa.html.

3. See FY 2017 Congressional Budget, Tax Division, U.S. Department of Justice at 11-12, available at <https://www.justice.gov/jmd/file/820916/download> (describing the Tax Division’s efforts to support the IRS in investigating undisclosed foreign accounts).

4. See Notice of Motion and Motion to Intervene, *In the Matter of Tax Liabilities*, No. 3:16-cv-6658, Dkt. No. 9 (N.D. Cal. Dec. 13, 2016).

5. United States’ Opposition to Motion to Intervene, *In the Matter of Tax Liabilities*, No. 3:16-cv-6658, Dkt. No. 15, at 6 (N.D. Cal. Dec. 27, 2016).