

## Protecting the Rights of Taxpayers Who Receive “Soft Letters” That Require Them to Provide Support for Their Return Positions and Sworn Statements Outside an Examination

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### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Be Informed*
- *The Right to Privacy*

### OVERVIEW

The IRS’s use of “soft letters” to educate, inform, and encourage voluntary compliance is a useful IRS compliance and enforcement tool. However, the IRS’s soft letters have been including language aimed at compliant taxpayers that requires them to produce documents and a detailed supporting statement signed under penalties of perjury. The soft letters, which may cover more than one tax period, request information not included on a return and possibly cover years outside the statute of limitations for assessment. The information requested is akin to an IRS examination but without providing the taxpayer rights and protections afforded by an examination. One example of such a soft letter request is for a taxpayer who had reportable virtual currency transactions (Letter 6173). It is the National Taxpayer Advocate’s position that these intrusive requests violate taxpayers’ rights and should not appear in any soft letters or communications outside the examination process.

### DISCUSSION

Over the years, the IRS has issued taxpayers “soft letters” for a variety of issues and purposes, including informing, educating, and encouraging voluntary compliance. However, the IRS has recently begun using some soft letters as a means to bypass the rights and protections of the examination procedures. One such example is Letter 6173, addressed to taxpayers with virtual currency transactions.

The IRS requires taxpayers to report whether they received, sold, sent, exchanged, or otherwise acquired any financial interest in any virtual currency on their annual tax return.<sup>2</sup> The Large Business and International (LB&I) Division has moved toward issue-based examinations and a compliance campaign process. The taxability of virtual currency is one such campaign that LB&I is focusing on in determining which taxpayers to select for examination.<sup>3</sup> In 2019, to combat virtual currency abuses, the IRS sent letters to over 10,000 taxpayers who potentially failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions

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1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

2 See IRS Form 1040, Schedule 1, used to file returns for tax year 2019.

3 IRS, IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns, IRS News Release (July 2, 2018), <https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns>.

properly.<sup>4</sup> Although we applaud the IRS's efforts involving virtual currency abuses, including increased use of data analytics, we do not believe the IRS should include compliant taxpayers in its soft letter campaign. Currently, there are three virtual currency letter variations: Letter 6173, Letter 6174, and Letter 6174-A.

It is the IRS's position that soft letters come in many varieties, tailored to the sophistication of the audience and issue(s) involved. Each letter specifies options for taxpayer action, if appropriate. Some letters merely inform the taxpayer that the IRS has observed certain information about them and highlights relevant law. The stronger letters result from observations suggesting higher risk of non-compliance on the part of the recipient and urge the taxpayer to respond by a specific date (*e.g.*, file an amended return or statement under oath) or risk further action by the IRS. None of these soft letters constitute the start of an examination, but the response, or lack thereof, will factor into the IRS's next steps intended to bring taxpayers into compliance. The IRS contends that soft letters are a service to the taxpayers who receive them because they are offered an opportunity to comply if they have not or to avoid an examination if they have complied, and it is a service to the broader taxpayer community as reporting and paying compliance increase, thus improving fairness to all. Soft letters may be a useful tool in educating taxpayers and may assist in future compliance. However, as drafted, Letter 6173 is not such a letter and crosses over from educating to imposing onerous taxpayer production burdens outside the arena of an examination.

### Compliant Taxpayers

What is disturbing about soft Letter 6173 is that it specifically addresses taxpayers who believe they are compliant and imposes unreasonable burdens on them outside the protection of an examination.<sup>5</sup> The IRS has stated that Letter 6173 is not an examination and therefore the IRS is not required to follow the examination guidance or provide taxpayers the rights afforded them in an examination. Yet, Letter 6173 fails to inform taxpayers that the letter is not part of an examination and as written appears to be a threat directed at taxpayers who believe they are compliant.

Specifically, for the taxable years 2013 through 2017, the letter instructs taxpayers as follows:

If you believe you followed all tax and information reporting requirements relating to your virtual currency accounts, mail or eFax the following to the address or eFax number shown at the top of this letter.

- A statement of facts explaining your position. Include a complete history of previously reported income from your virtual currency transactions. Explain the actions you took to become compliant with U.S. reporting requirements and provide copies of previously filed documents that confirm your compliance.

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4 IRS, IR-2019-132, IRS Has Begun Sending Letters to Virtual Currency Owners Advising Them to Pay Back Taxes, File Amended Returns; Part of Agency's Larger Efforts (July 26, 2019), <https://www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts>.

5 See, *e.g.*, IRC § 7605(b) (prohibiting unnecessary or repetitive examinations). See also IRS Pub. 3498, The Examination Process (explaining the examination process and taxpayers' rights before, during, and after an examination). Letter 6173 is not the only IRS letter that solicits an explanation from taxpayers who believe they complied with filing requirements. IRS Letter 6290 contains a similar request with respect to compliance with the Foreign Account Tax Compliance Act. LB&I declined to remove the request from Letter 6290.

- Your contact information, including your telephone number, complete address, and the address where you receive mail (if different).

- The following statements with your signature and date:

I, \_\_\_\_\_, declare under penalties of perjury that I have examined this entire document, including all attachments and accompanying statements, and that the enclosed is true, correct, and complete.

I also understand with respect to any submission that the IRS reserves the right to make further contacts with me and my representatives to clarify any written explanation or any other documents. Statements and documents sent under this option will be checked against information received from banks, financial advisors, and other sources for accuracy.

The letter instructs and demands that these taxpayers produce documents, together with written factual and legal support for a five-year period. Depending upon the taxpayer's specific facts and the date of the letter's issuance for some of these years the three-year assessment period may have closed.<sup>6</sup> It should be noted that the IRS has not required the above information to be provided on a tax return. Yet, the soft letter is requiring it. This request is what normally happens during an IRS examination but with the numerous procedural protections of an examination. The Code, Congress, and the IRS have repeatedly acknowledged taxpayers' rights and protections, and this letter not only does not provide them — it undermines them.

The request for an explanation made outside the audit process burdens taxpayers who believe they are *compliant* and undermines their *rights to be informed* and *to privacy*, which includes the right to expect that any IRS inquiry will be no more intrusive than necessary.<sup>7</sup> Moreover, the taxpayer may find it necessary to hire representation to review his or her records to provide a complete response and then still be subject to an examination later, long after the taxpayer's response, for which the taxpayer may again need representation. Letter 6173 is not consistent with the protections afforded taxpayers.<sup>8</sup> The request for a sworn written statement should be removed from Letter 6173.

### Non-Compliant Taxpayers

Letter 6173, like Letters 6174 and 6174-A, also addresses taxpayers who may have failed to include virtual currency on their return or who incorrectly reported the appropriate virtual currency tax consequences. The letters encourage the taxpayer to file an amended return or file a delinquent return. The letters fail to provide taxpayers with information about the application or assertion of penalties or interest should they ignore — or follow — this encouragement. Although the Code does not require taxpayers to file an amended return, it does encourage taxpayers to correct any incorrect positions set forth on the original return. One such encouragement is the ability to file a qualified amended return (QAR) that prevents the IRS from assessing the accuracy-related

6 See IRC § 6501.

7 TBOR, [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights).

8 LB&I declined TAS's recommendation to remove the request that compliant taxpayers provide additional information under a sworn statement from Letter 6173.

penalty.<sup>9</sup> A QAR is an amended return that corrects an error in a previously filed return prior to the IRS contacting the taxpayer regarding an examination of the return.<sup>10</sup> One question that arises is whether after sending Letters 6173, 6174, or 6174-A and then opening an examination, the IRS will contend the letters, although they are not examinations when sent, are a contact regarding an examination of a return, making the taxpayer ineligible for relief from the 20 percent accuracy-related penalty by filing an amended return.<sup>11</sup>

Another challenge with QARs is the exclusion for amended returns filed after the issuance of a John Doe summons.<sup>12</sup> If the recipients of Letters 6173, 6174, or 6174-A were identified pursuant to a John Doe summons, they are ineligible for QAR penalty relief.<sup>13</sup> The letters do not provide that information to the taxpayer. As a result, taxpayers may be subject to penalties even if they correct their returns before the IRS opens an examination.

### OBJECTIVES FOR FISCAL YEAR 2021

In fiscal year 2021, TAS will:

- Continue to work with LB&I toward removing burdens imposed on taxpayers who believe they are compliant resulting from soft letters such as Letter 6173;
- Work with the IRS and encourage guidance allowing accuracy-related penalty relief when filing a virtual currency amended return in response to Letters 6173, 6174, and 6174-A;
- Encourage the IRS to offer a positive incentive for taxpayers who receive Letters 6173, 6174, and 6174-A to disclose and correct errors by developing an administrative program for virtual currency reporting issues similar to the offshore disclosure initiatives to encourage voluntary compliance; and
- Work with the IRS on future soft letters to eliminate burdens on taxpayers by protecting their rights.

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<sup>9</sup> See IRC § 6662(d)(2)(B); Treas. Reg. § 1.6662-4(f).

<sup>10</sup> See Treas. Reg. § 1.6664-2(c)(3)(i)(A), which includes in the definition of “qualified amended return” an amended return filed before the taxpayer is first contacted by the IRS concerning any examination with respect to the return.

<sup>11</sup> See IRC § 6662(a).

<sup>12</sup> See Treas. Reg. § 1.6664-2(c)(3)(i)(D) and (c)(5), Examples 5 and 6.

<sup>13</sup> See Robert W. Wood and Joshua D. Smeltzer, *IRS Prepares for Battle on Cryptocurrency Reporting*, 166 TAX NOTES FEDERAL 601 (Jan. 27, 2020), which describes a John Doe summons issued to Coinbase that resulted in the release of information about 13,000 Coinbase customers.