Tax Basics & Practitioner Considerations for Virtual Currency

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Learning Objectives

- Recall the IRS definition of virtual currency and identify recent changes
- State which virtual currency transactions result in gains and losses for the taxpayer
- State the difference in tax treatment between a hard fork and a soft fork
- Identify situations where a taxpayer needs to file Form 8300

Virtual Currency – Overview

- Covered in IRS Notice 2014-21 & Revenue Ruling 2019-24

    - IRS.gov also has an FAQ page

- Virtual currency is a digital representation of value, other than a representation of the U.S. dollar or a foreign currency ("real currency"), that functions as a unit of account, a store of value, and a medium of exchange

- Normally treat virtual currency like any other property transaction

Recent Clarifications from IRS.gov

- Digital assets include **(but are not limited to):**

  - Convertible virtual currency and cryptocurrency
  - Stablecoins
  - Non-fungible tokens (NFTs)

- *"Digital assets are not real currency (also known as "fiat") because they are not the coin and paper money of the United States or a foreign country and are not digitally issued by a government's central bank."*

- *"A digital asset that has an equivalent value in real currency, or acts as a substitute for real currency, has been referred to as convertible virtual currency."*

Why is the IRS so concerned about virtual currency?

- The concern is mainly around the lack of regulation and oversight. For example, as of this writing, bitcoin is not traded on a regulated market.
- The IRS has added a disclosure at the top of the Form 1040 for taxpayers to disclose if they have had transactions in virtual currency.
- Taxpayers may or may not receive a 1099 depending on what platform they are using to trade virtual currency.

IRS FAQ 5 – Form 1040 Checkbox

"Q5. The 2021 Form 1040 asks whether at any time during 2021, I received, sold, exchanged, or otherwise disposed of any financial interest in any virtual currency. During 2021, I purchased virtual currency with real currency and had no other virtual currency transactions during the year. How do I answer the question on the Form 1040? (added March 10, 2022)

A5(a). If your only transactions involving virtual currency during 2021 were purchases of virtual currency with real currency, you are not required to answer 'yes' to the Form 1040 question, and should, instead, check the 'no' box."

Are digital assets subject to FBAR Reporting?

- FinCEN Notice 2020-2 says no.

- *"….At this time, a foreign account holding virtual currency is not reportable on the FBAR (unless it is a reportable account under 31 C.F.R. 1010.350 because it holds reportable assets besides virtual currency)."*

- *"However, FinCEN intends to propose to amend the regulations implementing the Bank Secrecy Act (BSA) regarding reports of foreign financial accounts (FBAR) to include virtual currency as a type of reportable account under 31 CFR 1010.350."*

IRS FAQ 46 – Records for Virtual Currency

"A46. The Internal Revenue Code and regulations require taxpayers to maintain records that are sufficient to establish the positions taken on tax returns. You should therefore maintain, for example, records documenting receipts, sales, exchanges, or other dispositions of virtual currency and the fair market value of the virtual currency."

- Practitioners should consider reminding clients that they are responsible for keeping records related to virtual currency.

What is a bitcoin ETF?

- The bitcoin ETFs that are currently being traded are not a direct investment in bitcoin. Typically, they are investments in companies that are investing in bitcoin.

- Bitcoin ETFs are traded on an exchange and are regulated like other ETFs. This may be a step towards mainstream acceptance of bitcoin.

- ETFs generally trade like a stock but are often more tax efficient than mutual funds. Dividends, interest, and capital gains (if any) are minimal. Generally, gain or loss is only recognized when they are sold.

Virtual Currency - Property Transactions

- Long-Term Capital Gain/Loss, if sold more than a year after acquisition
- Capital Losses may be taken to the extent of Capital Gains ($3,000 in losses for individuals)
- Capital Losses may be carried forward

Selling Virtual Currency

- A specific unit is identified by either documenting the unit's unique digital identifier or by records showing the transaction information

- If specific identification method is not used → First-In, First-Out (FIFO) method is used

- Amount received minus basis is the gain/loss

Example 1: Virtual Currency Sale

Evan buys 1 bitcoin at a cost of $450 on September 1, 2021. He then buys another bitcoin on January 1, 2022 at a cost of $500. He then sells 1 bitcoin for $600 on September 30, 2022. What should he report on his 2021 and 2022 tax returns?

In 2021, he would not report any gain or loss, nor would he check "yes" on his Form 1040 (since he only purchased bitcoin in 2021). In 2022, unless he used specific identification, he would show a $150 long-term capital gain. He would also check the "yes" box at the top of his Form 1040. When specific identification is not used, the first-in, first-out (FIFO) method is.

Virtual Currency Losses Due to Fraud?

- Fraud on cryptocurrency platforms has been problematic… Can I deduct a loss?

- Rev Proc 2009-20 allows taxpayers to take a loss on Ponzi schemes, but not specifically virtual currency fraud ***(REMEMBER: It was 2009 when it came out!)***

- Sec 165 allows taxpayers to take a loss on certain worthless securities:

(A)a share of stock in a corporation;

(B)a right to subscribe for, or to receive, a share of stock in a corporation; or

(C)a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

Chief Counsel Advice (CCA) 202302011

Section 165 of the Code provides for the deduction of losses sustained during the taxable year. If Taxpayer A owns cryptocurrency that has substantially declined in value, has Taxpayer A sustained a loss under section 165 of the Code due to worthlessness or abandonment of the cryptocurrency?

No. Section 165 provides a deduction for losses that are evidenced by ***closed and completed transactions****, fixed by identifiable events, and actually sustained during the taxable year. Taxpayer A has not* ***abandoned or otherwise disposed*** *of the cryptocurrency, and the cryptocurrency is not worthless because it still has value. Therefore, Taxpayer A has not sustained a loss under section 165 and the corresponding regulations.*

KEEPING UP WITH THE CODE

Basis in Virtual Currency

- Just like any other property – amount paid plus commissions, fees, and acquisition costs
- Recognizing ordinary income for the virtual currency will result in basis

Receiving Virtual Currency

- Measured at the fair market value of the currency on the date of receipt
- *"In an on-chain transaction you receive the virtual currency on the date and at the time the transaction is recorded on the distributed ledger"* (IRS FAQ 3)
- If received as wages, subject to payroll taxes/self- employment taxes

IRS FAQ 28 – No Published Value

"Q28. I received cryptocurrency that does not have a published value in exchange for property or services. How do I determine the cryptocurrency's fair market value?

A28. When you receive cryptocurrency in exchange for property or services, and that cryptocurrency is not traded on any cryptocurrency exchange and does not have a published value, then the fair market value of the cryptocurrency received is equal to the fair market value of the property or services exchanged for the cryptocurrency when the transaction occurs."

Example 2: No Published Value

Josh does repair work on Matt's condo. Matt decides to pay Josh with virtual currency that has no published value. Josh accepts.

If Josh's services are normally $500, then Josh must declare $500 of ordinary income on his tax return. If there is not a published value for the virtual currency, then the fair market value of the services is used. This is similar to a barter transaction.

IRS FAQ 22 & 23 - Hard Forks

- *"A hard fork occurs when a cryptocurrency undergoes a protocol change resulting in a permanent diversion from the legacy distributed ledger"*
- May or may not result in new cryptocurrency on a new distributed ledger
- No New Cryptocurrency → No Taxable Income

Hard Forks Cont'd

- If the hard fork results in additional value (new cryptocurrency), ordinary income must be recognized.
- Measured at fair market value on date received
- Taxable income in the year received

Soft Forks

"A soft fork occurs when a distributed ledger undergoes a protocol change that does not result in a diversion of the ledger and thus does not result in the creation of a new cryptocurrency" (IRS.gov)

No new cryptocurrency in a soft fork → No taxable income

Paying with Virtual Currency

- If you pay for a service/property with virtual currency, you recognize a capital gain/loss
- Gain/Loss is the difference between the fair market value on the date paid and the basis in the virtual currency
- Treated as if you sold the virtual currency first, then paid with US currency

Example 3: Paying with Virtual Currency

Li buys 1 bitcoin at a price of $450 on December 1, 2022. Her tax accountant agrees to accept 1 bitcoin as payment for 2022 tax preparation services on April 1, 2023. On that date, bitcoin was trading at $600.

Li must recognize a short-term capital gain of $150 on her 2023 tax return. When Li pays for her tax preparation services, it is as if the bitcoin was sold at market value and the cash was used to pay for the return.

If Li had owned the bitcoin for over a year, it would be a long-term capital gain.

Paying with Virtual Currency Cont'd

- Must issue W-2s if you pay employees with virtual currency
- Must issue 1099s as well ($600 or more)
- If you exchange virtual currency for property, you recognize gain/loss based on the difference between the FMV of property received and the basis of the virtual currency paid

Chief Counsel Advice (CCA) 202035011

Is convertible virtual currency received by an individual for performing a microtask through a crowdsourcing or similar platform taxable income?

Yes, a taxpayer who receives convertible virtual currency in exchange for performing a microtask through a crowdsourcing platform has received consideration in exchange for performing a service, and the convertible virtual currency received is taxable as ordinary income.

Charitable Donations of Virtual Currency

- No recognition of gain or loss on a charitable donation
- If virtual currency has been held for more than a year, the deduction is normally the FMV of the virtual currency
- If virtual currency has been held for 1 year or less, donation is lesser of FMV or basis of virtual currency at the contribution date

IRS FAQ 37: Charity Reporting

- Charities should treat contributions in virtual currency as non-cash transactions.

- "Charities report non-cash contributions on a Form 990-series annual return and its associated Schedule M, if applicable. Refer to the Form 990 and Schedule M instructions for more information."

- "Charities must file Form 8282, Donee Information Return, if they sell, exchange or otherwise dispose of charitable deduction property (or any portion thereof) - such as the sale of virtual currency for real currency as described in FAQ #4 - within three years after the date they originally received the property and give the original donor a copy of the form. See the instructions on Form 8282 for more information."

Chief Counsel Advice (CCA) 202302012

- *Is Taxpayer A required to obtain a qualified appraisal under section 170(f)(11)(C) of the Code for contributions of cryptocurrency for which Taxpayer A claims a charitable contribution deduction of more than $5,000?*

- *Yes. If Taxpayer A donates cryptocurrency for which a charitable contribution deduction of more than $5,000 is claimed, a qualified appraisal is required under section 170(f)(11)(C) to qualify for a deduction under section 170(a).*

Chief Counsel Advice (CCA) 202302012

- *If Taxpayer A is required to obtain a qualified appraisal under section 170(f)(11)(C) of the Code and fails to do so, does the reasonable cause exception provided in section 170(f)(11)(A)(ii)(II) apply if Taxpayer A determines the value of the cryptocurrency based on the value reported by a cryptocurrency exchange on which the cryptocurrency is traded?*

- *No. If Taxpayer A determines the value of the donated cryptocurrency based on the value reported by a cryptocurrency exchange on which the cryptocurrency is traded rather than by obtaining a qualified appraisal, the reasonable cause exception provided in section 170(f)(11)(A)(ii)(II) will not excuse noncompliance with the qualified appraisal requirement, and Taxpayer A will not be allowed the charitable contribution deduction under section 170(a).*

Gifts of Virtual Currency

- Normal gift tax rules apply
- $16K per donor per donee annual exclusion (2022)
- When selling gifted virtual currency:

1. Gain Basis is Donor Basis plus Donor Gift Taxes Paid
2. Loss Basis is lesser of Donor Basis or FMV on Date of Gift

Infrastructure Investment and Jobs Act

- Passed on November 5, 2021 – Mostly concerning spending on infrastructure, but two notable issues in taxation.
- Cryptocurrency – Form 8300 reporting required after 2022
- Employee Retention Credit – Now suspended after September 30, 2021

Form 8300

- Must report transactions of cash received in the amount of $10,000 or more in a single transaction (or related transactions) in the course of a trade or business.

- Reporting requirements apply to any “person” – meaning any taxpayer including individuals, trusts/estates, corporations, etc.

- There are various rules that must be applied to determine if transactions are “related” for this purpose. Taxpayers may also voluntarily report transactions that may not fit the specific requirements.

Form 8300 – "Related Transactions"

- Any transactions occurring within a 24-hour period between a payer (or his/her agent) and the recipient
- Any transactions "if the recipient knows, or has reason to know, that each transaction is one of a series of connected transactions" even if they stretch beyond a 24-hour period.
- If a taxpayer receives more than one cash payment for a single transaction or for related transactions, he/she "must report the multiple payments any time you receive a total amount that exceeds $10,000 within any 12-month period."

Example 4: Form 8300

Melisa invoices Dave for a sale of a retail product for $10,508. Dave pays Melisa $4,508 on Monday, $2,000 on Tuesday, and $4,000 on Friday. All payments are made in cash. Even though the payments are made over more than a 24-hour period, Melisa should know that the payments are connected since they are all related to the same transaction. Therefore, Melisa would need to file a Form 8300.

Same facts as above except that Dave pays Melisa $4,508 in cash on March 15th. Six months later, on September 15th, Dave pays Melisa the remaining $6,000 due also in cash. Melisa would have a Form 8300 reporting requirement after receiving the second payment.

Form 8300 - Filing

- Generally due 15 days after the cash payment is received (or if in a series, 15 days after the payment is received that put the taxpayer over the $10,000 threshold). When the due date falls on a holiday or weekend, due the next business day.

- If more than one report is due for a 15-day period, the taxpayer can file a combined report.

- Filings must be retained for a period of at least 5 years.

Cryptocurrency Reporting – Form 8300

- **Broker** - includes anyone who for consideration effectuates the "transfers of digital assets on behalf of another person."

- **Digital Asset** - "any digital representation of value recorded on a cryptographically secured distributed ledger or any similar technology.

Summing It Up

- In general, virtual currency is treated just like any other property transaction. Gains and losses are normally capital and the holding period is based on the amount of time owned.
- Ordinary income must be recognized when the taxpayer receives additional value as a result of the transaction (for example, a hard fork).
- Form 8300 reporting requirements apply to cryptocurrency. The form must be filed by any "person."

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