Understanding the Tax Implications of Cryptocurrency

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The IRS focuses on cryptocurrency for two primary reasons: trading cryptocurrency is a taxable event and converting cash into virtual currency is a way to launder money.

This focus resulted in the IRS releasing guidance on the reporting and taxation requirement for the sale, purchase, and trade of cryptocurrency—but some grey areas remain.

To help you understand the tax implications of cryptocurrency, our article will address:

- Buying and Selling Cryptocurrency
- What's Your Tax Rate for Cryptocurrency Capital Gains?
- What Cryptocurrency Transactions Can Be Taxed?
- Foreign Reporting Requirements
- Why Can't Cryptocurrency Exchanges Provide Accurate Tax Forms?
- When Should You Consult a Tax Professional About Your Cryptocurrency?

Buying and Selling Cryptocurrency

The IRS issued Notice 2014-21 on March 25, 2014, which, for the first time, set forth the IRS position on the taxation of virtual currencies such as bitcoin.

According to the notice, "Virtual currency is treated as property for U.S. federal tax purposes." The notice further stated, "General tax principles that apply to property transactions apply to transactions using virtual currency."

In other words, the IRS treats income or gains from the sale of a virtual currency as a capital asset that's subject to either short-term or long-term capital gains tax rates if the asset is held for more than 12 months.

If it's held for more than 12 months, the asset is taxed at either:

- 15%
- 20% based on your adjusted gross income

The IRS increases the long-term capital gain tax percentages for taxpayers in higher income tax brackets. An additional 3.8% net investment income tax (NIIT) may also be applicable given a taxpayer's adjusted gross income level; this is applied on short-term and long-term held virtual currency.

By treating bitcoin and other virtual currencies as property instead of currency, extensive record-keeping rules are imposed, and significant taxes may apply.

For record keeping purposes, an individual's cost basis is what they pay for the cryptocurrency, and the spread is taxable when they use or sell the cryptocurrency assuming it's appreciated in value since purchase. If the value declined since purchase, then it's a capital loss.

What's Your Tax Rate for Cryptocurrency Capital Gains?

General accounting and tax principles apply to cryptocurrency for purposes of capital gain tax treatment. However, certain activities, such as mining, could be subject to ordinary tax rate treatment. IRS Notice 2014-21 (https://www.irs.gov/pub/irs-drop/n-14-21.pdf) outlines these activities.

Additionally, if you receive compensation from services in the form of cryptocurrency, these could be subject to employment or self-employment taxes similar to other compensatory payments received.

What Cryptocurrency Transactions Can Be Taxed?

The following cryptocurrency transactions can be taxed:

- Exchanging cryptocurrency for other cryptocurrency
- Mining cryptocurrency
- Paying for goods and services with cryptocurrency
- Hard forks and split chains
- Donating cryptocurrency
- Decentralized Finance (DEFI)

Exchanging Cryptocurrency for Other Cryptocurrency

Taxpayers commonly used to ask the question whether cryptocurrency exchanged for other cryptocurrency without USD ever received was a taxable event. The short answer is yes, the IRS appears to view these exchanges as taxable events.

IRC Section 1031 (https://www.irs.gov/pub/irs-news/fs-08-18.pdf), known as the like-kind exchange rules, used to apply to real and personal property, however, the rules changed in 2018 to apply only to real property. *Real property* is land or any permanent fixtures attached to that land; *personal property* isn't permanently affixed to either.

Even before the updated rules, it was considered an aggressive approach to apply them to cryptocurrency. Now that they're only allowed for real property, it's clear a taxpayer can't utilize Section 1031 to defer a crypto-to-crypto exchange.

Mining Cryptocurrency

IRS Notice 2014-21, *IRS Virtual Currency Guidance*, states that taxpayers earn taxable income when they receive a block reward of virtual convertible currency for successfully mining a new block on the blockchain.

The taxable income earned is the determinable fair market value (FMV) in US dollars of the virtual convertible currency earned from the block reward. This income is considered ordinary income and the amount reportable is based on the FMV of the cryptocurrency at the time it was successfully mined.

Retirement-account investors interested in mining bitcoin—versus trading bitcoin—should be aware that such activity could be subject to the unrelated business taxable income tax rules if the mining is deemed a trade or business.

Paying for Goods and Services with Cryptocurrency

IRS Notice 2014-21 (https://www.irs.gov/pub/irs-drop/n-14-21.pdf) Question 4 addresses how to treat virtual currency received as payment for goods or services.

IRS Notice 2014-21 (https://www.irs.gov/pub/irs-drop/n-14-21.pdf) Question 6 addresses whether gain or loss should be recognized when exchanging virtual currency for other property.

When a business receives cryptocurrency for services or as payment for goods, the business is required to recognize revenue when payment is received.

If a business receives one Bitcoin (BTC) valued at $20,000, and then two months later decides to use that BTC to pay for an expense when the BTC appreciated to $30,000, the company would need to recognize gain on the spread of $10,000 when the BTC is exchanged.

This can become a complicated scenario for companies that don't have tracking in place to identify the original cost basis of the cryptocurrency being used. The complexity increases with the frequency of payments.

Hard Forks and Chains Splits

The IRS drafted Revenue Rule 2019-24 (https://www.irs.gov/pub/irs-drop/rr-19-24.pdf) to address whether a taxpayer has gross income under Section 61 as a result of a hard fork.

A *hard fork*, in simple terms, is when a single cryptocurrency splits in two. This occurs when a cryptocurrency's existing code is changed, resulting in both an old and new digital asset. A hard fork requires all nodes or users to upgrade to the latest version of the protocol software simultaneously.

There are different ways a hard fork can play out, including:

- **No new cryptocurrency.** If you didn't receive any new crypto, you therefore don't have taxable income. It's a protocol upgrade that doesn't impact or change the property in the hands of the taxpayer. This is sometimes called a soft fork.

- **New cryptocurrency.** New crypto received is taxable ordinary income in the year received. The determination of receipt can be complicated.

Section 61 states that all gains or undeniable accessions to wealth, clearly realized, over which a taxpayer has complete dominion, are included in gross income.

The Revenue Ruling focuses on two elements:

- **Accessions to wealth**. An increase in the value of property
- **Complete dominion**. This isn't defined in the Revenue Ruling, but likely means the ability to exercise control over the new cryptocurrency.

A hard fork results in a new distributed ledger and a new cryptocurrency, even while the taxpayer still owns the legacy cryptocurrency. As a result, one ends up with an accession to wealth.

The IRS believes the new distributed ledger meets the accession to wealth requirement, and should include cryptocurrency received as a result of a hard fork as ordinary income.

However, if you're supposed to receive cryptocurrency as a result of a hard fork but can't access or control the new forked cryptocurrency, then it might not be taxable until you have access or control.

For example, if you had crypto on a Coinbase account and the newly forked coin wasn't supported by Coinbase, you're unable to access the new cryptocurrency.

In this scenario, it seems the IRS suggests it wouldn't be a current taxable event. The key is whether you also have dominion, or control, over the cryptocurrency.

Donating Cryptocurrency

The first step is to confirm that the charitable organization or charitable vehicle is a qualified 501(c)(3) charitable organization (https://www.irs.gov/charities-non-profits/charitable-organizations/exemption-requirements-501c3-organizations), and then confirm they're able to receive cryptocurrency as a donation.

Your tax deduction will equal the fair market value of the donated bitcoin, assuming the property was held for more than one year. Rules for donating cryptocurrency would fall under the property limitations since the IRS treats cryptocurrency as property under IRS Notice 2014-21.

Note that for the purposes of this topic, we're commenting only on donations directly to charitable organizations or donor-advised funds.

Decentralized Finance (DeFi)

Decentralized finance (DeFi) is quite popular in the cryptospace. DeFi space includes platforms that allow users to utilize their crypto holdings to earn interest similar to peer-to-peer lending or earning interest on cash in a bank account.

Many questions pop up with regards to tax treatment of these new activities, including staking, yield farming, liquidity mining, and crypto lending.

Blockchain technology allows new platforms to pop-up, essentially eliminate banks, and connect users with large amounts of crypto to lend to various networks.

In return, they could be rewarded with more cryptocurrency. These rewards would likely be taxable assuming they meet both the accession to wealth and dominion requirements discussed earlier. What the character of the taxable event is and when it's taxable is the more complex question.

Foreign Reporting Requirements

Taxpayers must file Financial Crimes Enforcement Network (FinCEN) Form 114 (https://www.fincen.gov/report-foreign-bank-and-financial-accounts), *Report of Foreign Bank and Financial Accounts*, and Form 8938 (https://www.irs.gov/pub/irs-pdf/f8938.pdf), *Statement of Specified Foreign Financial Assets*, if reporting thresholds are met for cryptocurrency held in a foreign account.

For married joint filers, the thresholds for FinCEN Form 114 are an aggregate value of $10,000 or more at any point during the year, and the reporting threshold for Form 8938 is either an aggregate value of:

- $100,000 or more on the last day of the year
- $150,000 or more at any point during the calendar year

The FinCEN Form 114 is a standalone filing while the Form 8938 is filed with an individual's tax return. Both forms are due by April 15, with the option to extend until October 15.

Why Can't Cryptocurrency Exchanges Provide Accurate Tax Forms?

The biggest reason cryptocurrency exchanges can't provide tax reporting information is likely the fact that they simply aren't required to and considered outside the traditional brokerage reporting requirements.

Some larger crypto exchanges are proactive and provide reporting information on crypto transaction including Robinhood and Coinbase.

When Should You Consult a Tax Professional About Your Cryptocurrency?

If you realize you should have reported cryptocurrency transactions in a past year, you may want to consider reaching out to a CPA or tax professional.

Some taxpayers also could miss out on capital losses that could be carried forward to offset capital gains in future years. If your crypto transactions are quite frequent or substantial, it may be a good idea to seek a tax professional.

The more a person or business trades cryptocurrency, the harder it can be to track your tax basis. It's always best to have a conversation, seek assistance ahead of time, and be proactive instead of reactive.

IRS Enforcement

President Biden announced his administration will allocate roughly $80 billion in funding (https://www.cnbc.com/2021/07/14/irs-new-rules-on-bitcoin-ethereum-dogecoin-trading.html) over the next decade to build out a dedicated IRS task force focused on virtual currency transaction reporting and compliance.

There will likely be a push for crypto exchanges that have never been required to report information to their customers to begin reporting along the lines of a brokerage firm.

On May 20, 2021, the US Department of the Treasury also announced (https://www.cnbc.com/2021/05/20/us-treasury-calls-for-stricter-cryptocurrency-compliance-with-irs.html) it will require businesses, exchanges, and individuals to report crypto transactions totaling more than $10,000 during a tax year to the IRS.

Both announcements suggest the future of crypto will likely see a crackdown in the form of more reporting, more IRS audits, and possibly stiffer future penalties. The Biden administration believes these efforts could raise $700 billion over the next decade.

We're Here to Help

For more information on how IRS guidance on cryptocurrency could affect your next tax return, contact your Moss Adams professional.

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