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Income tax implications of cryptocurrency transactions

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Cryptocurrencies, such as Bitcoin, continue to make headlines. Whether held for investment or use as currency in everyday-type transactions, their prevalence in the U.S. has rapidly increased. What's often not considered, however, are the associated tax implications. With the 2017 tax filing season upon us, you should be aware that the IRS has several new initiatives in process to assure that these transactions are reported.

Here's what you should know about the IRS initiatives and the U.S. income tax implications and reporting requirements of transactions in cryptocurrencies, coins, tokens and other virtual assets.

Is the IRS trying to track these transactions?

The IRS searched the roughly 126 million electronically filed tax returns that were filed for 2013–2015, and found that only approximately 800 individuals reported transactions related to Bitcoin, the most popular of the cryptocurrencies, on their tax returns. Those figures mean it's extremely likely that taxpayers aren't reporting their cryptocurrency transactions and the IRS has taken steps to remedy the issue.

- IRS has reportedly hired a cryptocurrency software company to trace and provide reports on cryptocurrency transactions.
- In November 2017, the IRS secured an order from a federal district court directing the enforcement of a summons against Coinbase, one of the major cryptocurrency exchanges. This order has provided the IRS with the identities and transaction histories of 14,000 Coinbase customers, each of whom had over $20,000 of cryptocurrency trades between 2013 and 2015.
- By investigating how these Coinbase customers obtained their crypto, the IRS will easily be able to identify and assess penalties against:
  - Employers that issued it as compensation but failed to properly report it on Form W-2 and remit the necessary tax withholdings
  - Individuals or entities that issued it to independent contractors but failed to properly report it on Form 1099-MISC

    - Cryptocurrency exchanges that failed to properly report transactions on Form 1099-B
- The IRS has just completed a very successful effort to uncover and prosecute individuals with unreported income from foreign bank accounts. The same investigation and enforcement techniques could easily be used to identify unreported cryptocurrency transactions.
    - A partial amnesty program provided incentives for voluntary disclosure of previous omissions. Since 2009, over 56,000 taxpayers participated in that program, and paid $11.1 billion in back taxes, penalties and interest on the unreported income.
    - Each year the Justice Department discovers, convicts and incarcerates over 2,000 individuals for tax evasion. The statistics show increasing numbers of these are related to undisclosed offshore bank accounts.

What cryptocurrency transactions are taxable?

According to IRS Notice 2014-21, for income tax purposes, the IRS treats cryptocurrencies as property, not currency. This is an important distinction because it means ***any time a cryptocurrency is sold or exchanged it is a taxable transaction for U.S. tax purposes.***

It's important for taxpayers to understand that the cryptocurrency transactions described in this alert are taxable even if the taxpayer doesn't receive 1099 forms or year-end statements.

Here's a list of the most common taxable cryptocurrency transactions, all of which are taxable:

- When it is sold or exchanged, whether for fiat currency (such as dollars) or another virtual currency
- When it is spent, such as to purchase goods or services
- When it is received as compensation for services
- When it is mined or received during a hard fork
- When a token is sold in an initial coin offering, or ICO

How are the transactions taxed?

Selling or exchanging cryptocurrencies

Gains and losses on the sale and exchange of cryptocurrencies are calculated just as those for the sale of stock. The formula to calculate them is the fair market value (FMV) of the proceeds, property, or services received less the basis in the cryptocurrency asset sold. Generally, a taxpayers' basis in cryptocurrency will be the amount they originally paid for it, the amount reported as income when it was received as compensation, or zero when it is given away for free, or airdropped. Note, all gains or losses on the sale of cryptocurrencies must be reported in U.S. dollars.

Whether or not a cryptocurrency is deemed a capital asset depends on the taxpayer's purpose for holding it. Generally, if it's held for investment or personal use (e.g., everyday transactions), it is considered a capital asset and therefore is eligible for the lower capital gains taxes rates. If held for one year or less, any gain would be taxed at the same rate as ordinary income. However, if held for greater than one year, the gain is taxed at the preferential capital gains rates—0%, 15% or 20% depending on the taxpayer's tax bracket. The gains or losses should be reported on Form 8949 as part of Schedule D on a taxpayer's personal income tax return.

These gains may also be subject to the additional 3.8% net investment income tax, if the taxpayer's income exceeds a certain threshold. If a cryptocurrency was held as inventory and used in the normal course of business (e.g., by a cryptocurrency dealer), it is a noncapital asset and taxed as ordinary income.

If a cryptocurrency is exchanged for another type of cryptocurrency, due to the passing of the Tax Cuts and Jobs Act in December of 2017, tax can no longer be avoided by way of the like-kind exchange rules. The like-kind exchange rules were repealed for exchanges of property other than real property occurring after December 31, 2017.

Using cryptocurrency like currency to purchase other goods or services

Because all sales or exchanges of cryptocurrencies are taxable transactions, taxpayers that use them in place of cash to make purchases must report the gain or loss from each one of these transactions, which may come as an unpleasant surprise. Further, due to the extreme volatility that some cryptocurrencies experienced in 2017, such as Bitcoin, the gains generated on these transactions may be significant. This may leave some taxpayers with an additional income tax bill they weren't expecting.

Receiving cryptocurrencies as compensation

When cryptocurrency is received as compensation for services performed, the FMV on the date of receipt is taxable as ordinary income, just as compensation paid in cash would be. If an employer pays an employee in cryptocurrency, it's generally treated as "wages" and subject to federal income tax withholding, FICA and unemployment taxes, and reported on a W-2. Cryptocurrency paid to an independent contractor has the same Form 1099 reporting requirements as compensation paid in cash.

Complying with the withholding and reporting requirements is particularly challenging where the virtual currency does not have a readily determinable FMV (e.g., compensation paid in the form of a token for working on a platform on which the token will be used).

Receiving cryptocurrencies as a result of mining

Taxpayers may also receive cryptocurrency by way of "mining." Mining, in greatly simplified terms, is when a person uses specific computer hardware and software to validate complex mathematical transactions that make up the blockchain, or public ledger. The "miner" receives compensation in the form of small fractions of a cryptocurrency at a time for their validation efforts. For tax purposes, the mined cryptocurrency assets are taxable as ordinary income at their FMV upon receipt. Further, if the mining is part of a taxpayer's trade or business and not merely a hobby, self-employment taxes up to 15.3% may be applicable to the net income.

Receiving cryptocurrency through "hard forks"

A "hard fork" occurs when a single cryptocurrency splits into two different cryptocurrencies or bifurcates onto multiple blockchains. As an example, a hard fork occurred when bitcoin split into bitcoin and bitcoin gold. Since the IRS has not provided any guidance on hard-fork transactions, taxpayers are expected to apply the normal tax rules for the receipt of additional property.

Under normal constructive receipt principles, such property is taxable at its FMV on the date it becomes freely available to the recipient, regardless of whether the recipient takes the action necessary to assume control. This rule applies even though it may be difficult to determine the property's FMV.

What type of record keeping is necessary?

In order to calculate gains and losses taxpayers will need the following:

- Date the cryptocurrency asset was acquired and its purchase price
- Date the cryptocurrency asset was sold or exchanged and the proceeds received

If an exchange, like Coinbase, is used to buy or sell cryptocurrency, users can download all of their transaction data from the exchange to a .csv file and import it into an Excel file for easier use. There is also software, such as CoinTracking.Info and Bitcoin.Tax, into which the .csv file can be uploaded that helps put everything in order for tax purposes and is free depending on the number of transactions. However, if this software is used, taxpayers should check with a tax professional to ensure the method used to calculate gains and losses complies with IRS rules.

If a taxpayer doesn't use an exchange for their cryptocurrency transactions, however, all tracking responsibility falls on their shoulders. In such cases, it may be easiest for taxpayers to keep track of their basis by using separate online wallets for each cryptocurrency purchase, and to document when each wallet was established, so the value of the cryptocurrency on the date of its acquisition can be determined.

Are there any disclosure requirements?

U.S. taxpayers are required to file a Report of Foreign Bank and Financial Accounts (FBAR) to disclose any foreign bank accounts in which they have an interest, or over which they have signature authority, and which has an aggregate value over $10,000 at any time during the year. How these rules apply to holders of cryptocurrency are unclear at best. Based on the Financial Crimes Enforcement Network's guidance provided in FIN-2013-G001, although not entirely clear, it appears taxpayers who have accounts in foreign cryptocurrency exchanges may be required to disclose them on an FBAR. It can be difficult to accurately report the maximum balance of your account during the year on an FBAR, as you are required to do, because of the volatility of the value of cryptocurrencies and the lack of tracking and statements.

It is important to note that a taxpayer who "willfully" avoids filing can be subject to a steep civil penalty of $100,000 or 50% of the balance in the foreign account—whichever is greater. There may also be criminal penalties similar to those levied against persons that did not declare offshore bank accounts.

As investment in and the use of cryptocurrencies continues to become more prevalent, the IRS is likely to release further guidance for taxpayers and continue working to find a solution to enforce the tax rules.

For more information on the content of this alert, please contact your regular Nixon Peabody attorney or:

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