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Virtual Currencies

Virtual currencies or cryptocurrencies are a digital representation of monetary value that may be issued, managed, and controlled by private issuers, developers, or the founding organization and functions as a medium of exchange, a unit of account, and/or a store of value. Virtual currencies are often represented in terms of tokens and may remain unregulated without a legal tender. Unlike government currencies, virtual currency relies on a system of trust and are typically not issued by a banking regulatory authority. They derive their value based on the underlying mechanism, like mining in cases of cryptocurrencies. There are many hundreds of virtual currencies, but the largest at this time are Bitcoin/BTC, Ethereum/ETH, Ripple/XRP, Tether/USDT, Litecoin/LTC and EOS.

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The IRS is making reporting cryptocurrency a compliance priority, staring with a new, particular question on the 2019 tax return. Right at the top of Schedule 1, where taxpayers report other income such as business income (Schedule C), rental real estate, partnership of S Corp. income (Schedule E), and miscellaneous income, they ask, "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

SCHEDULE 1
(Form 1040 or 1040-SR)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040 or 1040-SR.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2019
Attachment Sequence No. 01

Name(s) shown on Form 1040 or 1040-SR | Your social security number

At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? . . . . . ☐ Yes ☐ No

The IRS has initiated educational efforts on the topic, and, in July of 2019, the IRS announced that it was sending letters to over 10,000 taxpayers with virtual currency transactions inquiring about unreported income. Failure to properly report virtual currency transactions may subject you to IRS audit and you are subject to penalties and interest on unreported income or gains. In the most extreme cases, the negligent taxpayer could face prison time and a fine of up to $250,000.

For tax purposes, virtual currency is treated as property (similar to stocks or bonds), so taxpayers should maintain cost records in the same way records are kept for stocks and securities, even though they may not be provided monthly statements by an exchange intermediary or broker.

So, in the essential concept is this:

- For those taxpayers buying and selling cryptocurrency as an ***investment***, calculating gains and losses are figured the same as buying and selling stock, with short- and long-term gains.
- For those who are treating cryptocurrency as a ***transaction payment method*** like cash or credit cards, spending it directly for goods or services, the individual transactions may result in a gain or a loss.

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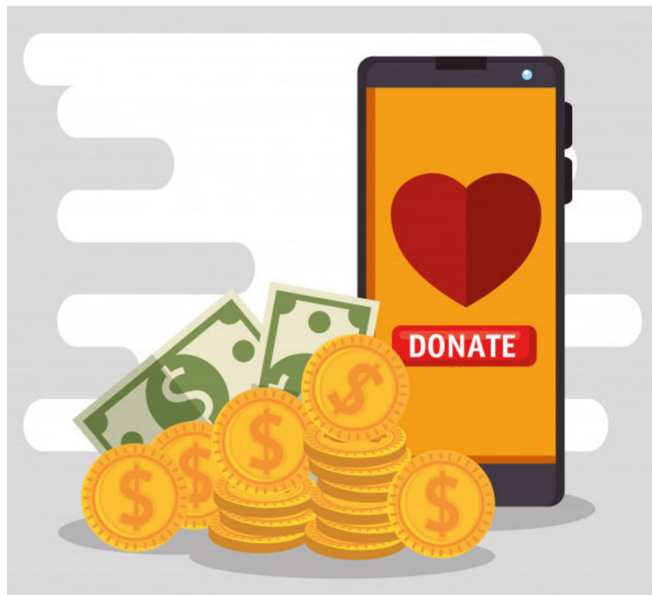
Those who are using cryptocurrencies as an investment, are likely to be aware of the nature of activities and the tax reporting requirements, however those who are using virtual currencies as a means of payment in trade (user), could easily miss the tax consequences of receiving in payment (taxable income of some sort) or using it to make payment (trade/sale which is reportable and on which capital gain or loss is recognized. When it comes to cryptocurrency, a taxable event occurs whenever it is traded for cash or other cryptocurrency or whenever cryptocurrency is used to purchase goods or services, without any exception for activity below a certain dollar threshold. Moreover, with an increasing number of traditional retailers or e-retailers accepting virtual currencies, this recognition problem is likely to escalate.

As of the current time, the IRS doesn't require third-party reporting for virtual currency (yet) so there's no form 1099-B or equivalent issued at the end of the tax year. As a result, both investors and users will have a hard time determining the cost basis of the cryptocurrency. If you are a trader in virtual currencies or engage in a significant volume of transaction activity, it is recommended that you invest in some tracking software specific to cryptocurrencies that will allow you to track your transactions.

The basis used to calculate cost invested, just like with publicly traded securities, is the cost in U.S. dollars of the original acquisition, along with any additional fees, commissions or other acquisition costs incurred in acquiring or disposing of the cryptocurrency.

Summary of Major Clarifications or Changes Announced by the IRS in 2019

Charitable giving: The IRS addressed whether gifting virtual currency to a charity could result in income, gain, or loss. The IRS confirmed that if you donate virtual currency to a charitable organization, you will not recognize income, gain, or loss from the donation. That's the same result as giving stock or other appreciated assets, which are also characterized as capital assets.



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The IRS also explained how to calculate the value of a gift of virtual currency to a charity. It's fairly simple: your charitable contribution deduction is generally equal to the fair market value of the virtual currency at the time of the donation. That's only true, however, if you have held the virtual currency for more than one year. If you have kept the virtual currency for one year or less, your deduction is the less of your basis (cost plus adjustments) in the virtual currency or its fair market value at the time of the contribution.

Transfers: What is now clarified by the IRS is this: transfers of virtual currency from an address, wallet, or account that you own, to another you own, is a non-taxable event, even if you receive an information return for the transfer, such as Form 1099-K.

Receiving Payments: The IRS clarified that receiving virtual currency in exchange for work performed is taxed as ordinary income and should be reported to the recipient on Form 1099 (for an independent contractor) or Form W-2 (for an employee).

Making Payments: When a taxpayer makes a payment, they have a capital gain or loss. This is the difference between the fair market value of the goods received, and the adjusted basis in the virtual currency exchanged.

TETHER

Forks: If you are virtual currency savvy, you may be familiar with "hard forks" and "soft forks." A hard fork is a "protocol change" in "distributed ledger technology." For hard forks, if you have "dominion" over the new currency, meaning you can transfer, sell, exchange, or otherwise dispose of it, ordinary income is recognized. A soft fork is 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. Soft forks are not taxable because taxpayers are not getting new cryptocurrency.

EOS

Foreign Account Reporting: The IRS FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), requires taxpayers who have total foreign bank accounts or investments valuing in excess of $10,000 to disclose these items annually with their tax return or else face large penalties. As of this time Virtual Currencies are not consider foreign currencies or investments reportable on the FBAR.

More IRS guidance via IRS FAQ:
https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions
Please note, although IRS FAQ do provide guidance for taxpayers, they are technically not legal authority and further investigation of authoritative guidance such as IRS Revenue Rulings 2019-24 and 2014-21.

Contact us to assist you with any of your complicated income tax matters. You may call us at 407-847-7466 or email us at taxes@sbc-cpa.com.

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