



Virtual Currency Transactions and Form 1040



Introduction

•According to a survey done by the Pew Research Center whose results were published in November 2021, 16% of Americans indicated they personally have invested in, traded or otherwise used virtual currency. Additionally, the number of people investing in or engaging in transactions involving virtual currency continue to increase. These statistics strongly suggest that tax preparers must be aware of the nature of virtual currency and its tax treatment. It's to provide that awareness that Tax Treatment of Virtual Currency was written.

•The Pew Research Center fact sheet may be accessed at <https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/>



Course Learning Objectives

- recognize the methods of obtaining and storing virtual currency
- describe how transactions involving virtual currency work
- understand the basic nature of blockchains
- apply the existing U.S. tax laws to virtual currency transactions
- identify when and where to report taxable virtual currency events and transactions

Basics and Details to Follow

- Nature of Virtual Currency
- Tax Treatment of Virtual Currency
- Key Terms



Chapter 1-Nature of Virtual Currency

Virtual currency use appears to be increasing continually and, according to a Pew survey, roughly 3 in 10 Americans younger than age 30 indicate they have invested in, traded, or used a virtual currency, such as Bitcoin or Ethereum. As a result, tax preparers are more likely than ever to encounter clients who have engaged in one or more virtual currency transactions during the year and who may have taxable income as a result. This chapter begins the course with a discussion of the nature of virtual currency and how transactions in virtual currency occur and are recorded.

Learning Objectives

- describe virtual currency
- explain how central bank digital currency (CBDC) is used
- recognize how stablecoins differ from unbacked cryptocurrency
- describe how virtual currency networks maintain security
- recognize how blockchain is employed with respect to virtual currency transactions

Lexicon of Virtual Currency

- Understanding tax treatment requires:
 - Understanding the nature of virtual currency
 - Understanding the terms and language of virtual currency
 - Understanding the how and where of virtual currency existence

Virtual Currency Defined

- 2012-unregulated digital money issued and used within a specific community
- 2014-Notice 2014-21 used and accepted in the country of issuance, not legal tender
- 2019- Revenue Ruling 2019-24 a digital representation of value other than the U.S.\$ or foreign currency.
- 2021 (Sept.)- El Salvador declared Bitcoin legal tender



Digital Currency

- Virtual currency referred to as digital
- Method of payment entirely in electronic form
- Transferred using an online system
- May be regulated (CBDCs) or Unregulated
- Backed or Unbacked

Backed Cryptocurrencies-Stablecoins

- Fiat-backed stablecoin- secured by bank issued currency
- Commodity-backed stablecoin- tied to silver, gold, precious metals, tangible assets
- Crypto-backed stablecoin- backed by other digital currencies--volatile
- Algo-based stablecoin- backed by "smart contracts"-more stable

Unbacked Cryptocurrency

- Bitcoin, Ethereum are two-thirds of all unbacked crypto
- Value based on supply and demand
- Speculation driven

Obtaining Virtual Currency

- Mining- validated by "blockchain"; recorded in digital ledger
 - Credit recipient
 - Debit owner
 - Verified crypto miners are paid in "coins"
- Purchasing- platforms vary in service, security and fees
 - Coinbase, Voyager, Blockfi, Uphold, Kraken, Crypto.com
 - Entered into digital wallet

Speculation

- ICO- similar to IPO
- Little protection or disclosure
- High fraud potential
- Unregistered exchanges
- Unverified information



[This Photo](#) by Unknown Author is licensed under [CC BY SA](#)

Storing Virtual Currency

- Exchange Platform digital wallet
- Owner's digital wallet
- Security features-public or private keys
- Stored and transferred by various methods
 - Hot or Cold Storage

Types of Storage

- Cold Storage- not on internet
 - Thumb drive
 - Disconnected hard drive
- Hot Storage- internet connected
 - Desktop wallet
 - Mobile wallet
 - Online wallet

Virtual Currency Transaction

- Transfer of ownership- input vs. output
- Confirmation- "node" validates
- Security- encryption
 - Decentralized System
 - Private Key
 - Strong cryptography



Changes in Protocol-Forks

- Forks- change in protocol-2 blockchains
 - Hard Fork- permanent change
 - To correct a security risk
 - To reverse a blockchain transaction
 - To add functionality
 - To resolve a disagreement
 - Soft Fork- 1 blockchain
 - Airdrop



Blockchain

- Public ledger- all are welcome
- Private blockchain- closely controlled membership
- Full node- computer maintaining historical recording of transactions
 - Light/lightweight nodes- participants who connect to full node



Summary of Virtual Currency

- Unregulated digital money
- Representative of value-not \$ or foreign currency
- May be regulated by CBDC for financial institutional transactions
- Mining is the process of validating transactions
- May be purchased on a trading platform
- Is stored by the platform or the owner
- Uses a decentralized system, keys, strong encryption for security
- Blockchain is a history of transactions



Chapter 2- Tax Treatment and Reporting

•Virtual currency is treated as property for federal tax purposes. As such, the general tax principles that apply to property transactions generally apply to transactions using virtual currency. This chapter will examine various transactions and events involving virtual currency and their tax treatment. Among the topics considered are:

- the cost basis of virtual currency held by a taxpayer
- the gain or loss to be recognized on sales or exchanges of virtual currency
- the tax treatment of virtual currency received as a result of virtual currency "mining"
- the charitable deduction available to itemizing taxpayers for donations of virtual currency



Course Learning Objectives

- calculate the adjusted cost basis of virtual currency that is purchased, mined, or received as a gift
- calculate the adjusted cost basis of virtual currency
- apply existing tax law to transactions involving virtual currency
- describe the tax treatment of virtual currency given as a charitable gift
- recognize the tax treatment given virtual currency when less than all is sold, exchanged, or otherwise disposed of

Virtual Currency Transactions

- Similar to many other transactions and may be
 - purchased
 - used to pay for services rendered
 - received in payment for services or goods
 - sold or exchanged
 - given or received as a charitable or noncharitable gift
 - inherited

Determining the Cost Basis of Virtual Currency

- Personal property-all property that is not real
- Capital asset
- Amount of the owner's investment
- Depends on method of acquisition/disposition

Determining the Cost Basis of Virtual Currency

- Acquired-
 - Purchased
 - Received as payment for good or services
 - Inherited
 - Received as a gift
- Disposed of-
 - Sold or exchanged
 - Given as payment for goods or services
 - Given as a charitable donation

Cost Basis of Purchased Virtual Currency

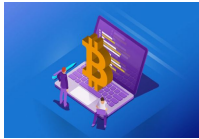
- Original costs plus
 - Fees paid
 - Commissions paid
 - Other acquisition costs



This Photo by Unknown Author is licensed under [CC BY-SA 4.0](https://creativecommons.org/licenses/by-sa/4.0/)

Cost Basis of Virtual Currency Received as Payment

- FMV
 - Published value if traded on exchange
 - Per definition of FMV if not
- U.S. \$ on date of transaction included in income
- IRS accepts value as determined by blockchain explorer



This Photo by Unknown Author is licensed under [CC BY-SA 4.0](https://creativecommons.org/licenses/by-sa/4.0/)

Cost Basis of Inherited Virtual Currency

- FMV on date of death or
- FMV on estate's alternate valuation date
- Adjusted Basis of decedent if gifted by recipient first

Community Property

- AZ, CA, ID, LA, NV, NM, TX, WA and WI
- Step-up applies to entire property
- Must be includable in estate

Virtual Currency Received as a Gift

- Donor's basis
- Gift tax paid on appreciation
- Gain or loss dependent

FMV Less/Greater than Donor's Adjusted Basis

- Gain or loss upon disposition depends... date of gift and gift tax may have implications
- FMV is less
 - Calculate Gain- basis equals donor's basis plus costs
 - Calculate Loss- basis equals FMV
- FMV is equal to or more
 - Gain or Loss- basis equals donor's basis plus costs

Cost Basis Summary

Virtual Currency Received	Cost Basis
As employee wages	FMV on date of receipt
As payment for independent contractor services	FMV on date of receipt
Inherited, other than in community property state	FMV on date of death or alternate valuation
Inherited in community property state	Stepped-up FMV of deceased and surviving spouse on date of death
As a gift	Donor's adjusted basis
As compensation for mining	FMV on date of receipt

Tax Treatment of VC Received for Services

- Wages, reported in U.S. \$ on W-2, subject to federal withholding, FICA, FUTA
- Self-employment income, reported in U.S. \$ on 1099-NEC, subject to backup withholding
- Payor disposes of virtual currency, a capital asset, in exchange for something of same value



Mining Virtual Currency

- Process of validating transactions
- Miner is paid in virtual currency—see previous slide for reporting
 - Costs incurred in mining are added to cost basis

Tax Treatment of Virtual Currency Transactions

- Exchanged Virtual Currency
- Exchange for Other Property
- Charitable Gifts
- Protocol Changes

Exchanged Virtual Currency

- Gain or loss- difference between amount received and adjusted basis
- Character is generally Capital following short and long term rules
- May be ordinary if inventory
- FMV of property received in exchange for virtual currency creates gain or loss
- Virtual currency exchanged for property creates gain or loss

Exchange of Virtual Currency for Other Property

- **Example 1.** Assume Audrey possesses virtual currency with a current FMV of \$100,000 that she is using to exchange for other property valued at \$100,000. If the virtual currency was purchased by Audrey for \$90,000, she would realize a gain of \$10,000 as a result of the exchange ($\$100,000 - \$90,000 = \$10,000$).

Exchange of Virtual Currency for Other Property

- **Example 2.** However, assuming the same set of facts except that she acquired the virtual currency as a result of an inheritance, and the FMV was \$100,000 at the time it was inherited, the result would be different. In this case she would realize no gain resulting from the exchange because her cost basis in the inherited virtual currency is equal to its FMV at the time of inheritance ($\$100,000 - \$100,000 = \$0$).

Exchange of Virtual Currency for Other Property

- **Example 3.** In the case of virtual currency received as a gift, there could be a third result. Assume Audrey received the virtual currency with an FMV of \$100,000 as a taxable gift and the donor had previously purchased the virtual currency for \$40,000. The taxable gift would have a gift tax value of \$84,000, i.e., the gift in excess of the applicable annual gift tax exclusion ($\$100,000 - \$16,000 = \$84,000$). If the gift tax paid by the donor was \$14,400, Audrey would have a cost basis in the gifted virtual currency of \$50,224, the total of the donor's cost basis *plus* the gift tax attributable to the increase in value ($\$40,000 + \$10,224 = \$50,224$).

When Less Than All Virtual Currency Held is Sold, Exchanged, or Disposed of

- Multiple units of same currency acquired at different times and costs
 - Taxpayer may identify units disposed of or FIFO will be used
- documenting the specific unit's unique digital identifier such as a private key, public key, and address; or
- records showing the transaction information for all units of a specific virtual currency held in a single account, wallet or address that includes –
 - the date and time each unit was acquired,
 - the taxpayer's basis and the FMV of each unit at the time it was acquired,
 - the date and time each unit was sold, exchange, or otherwise disposed of, and
 - the FMV of each unit when sold, exchange, or disposed of and the amount of money or the value of property received for each unit.

Charitable Gifts of Virtual Currency

- Deduction is FMV if held for more than 1 year
- Deduction is lesser of FMV or basis if held 1 year or less
- Contemporaneous written documentation of gift
- File 8283 if more than \$5000 and have signed by donee

Tax Treatment of Protocol Changes

- Hard fork does not result in taxable income
 - Unless units of a new currency are received (taxed as ordinary income)
- Airdrop creates taxable income
- Revenue Ruling 2019-24

Reporting

- Question added in 2020- "virtual currency" now replaced with "digital assets"
 - Check "Yes" if received, transferred, or disposed of digital assets.
 - Check "No" if held assets, transferred between own accounts, or purchased with real currency.
- All income must be reported whether or not information returns have been received creates taxable income

Reporting Digital Asset Transactions

- Use Form 8949 for gain/loss calculations.
- Report on Schedule D or Form 709 for gifts.
- Employees: report on Form W-2.
- Independent contractors: report on Schedule C.
- Report value in USD at compensation time.

Understanding the Question

- Did I receive virtual currency in exchange for goods or services?
- Have I paid for goods or services with virtual currency?
- Did I sell virtual currency during the tax year?



Recordkeeping

- Blockchain and the Distributed Ledger
 - Sequence of reporting financial data is blockchain (ledger)
 - The distributed ledger is when the blockchain is made public
 - Some transactions may occur "off-chain"

Summary

- Basis is determined by method of acquisition and disposition
- Virtual currency received as payment for services is taxable as wage or self-employment income
- Gain may be short or long term
- Charitable deductions may be basis or FMV
- Records must be maintained

Questions?



Cheryl@EBPI.com
info@mtbp.com
