E-GUIDE

Cryptocurrency and taxes

What you need to know

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Introduction

Cryptocurrency is a growing trend as millions of Americans now own some form of decentralized currency. Bitcoin, along with other forms of currency, is known as “cash for the internet” and is changing how online transactions are being handled.

As a tax professional, how you handle cryptocurrency taxation for your clients is a growing challenge. While owning this type of asset isn’t taxable, its disposition is, meaning that carefully documented records of each transaction must be kept. It’s your job to carefully weed through each of your client’s transactions and determine which qualify for taxation. This may seem like a tough job, but fortunately, we’ve created this guide to help.

Disclaimer: This material has been prepared for informational purposes only and is not intended to provide, tax, legal or financial advice. You should consult your own tax, legal, and accounting advisors before engaging in any transaction.

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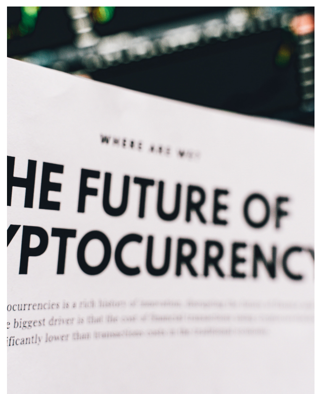
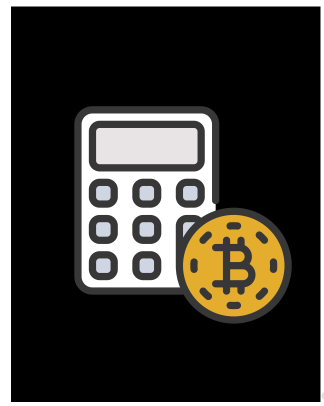




Cryptocurrency 101

Cryptocurrency

It's a type of virtual currency that uses cryptography to secure transactions. It's decentralized currency, meaning there's no government oversight into its supply. It was created in 2009 (post-financial crisis), and the most popular forms of crypto are Bitcoin and Ethereum.

Crypto exchanges

You can't just buy crypto from a bank or investing firm. Instead, you need to create an account on a crypto trading platform to exchange cash or other currency for digital assets. Some of the most popular crypto exchanges include Coinbase, Kraken, CoinEgg, and most recently Robinhood and PayPal.

Blockchain

All cryptocurrency transactions are anonymously recorded on digital ledgers known as blockchain. Each block in the chain contains several transactions, and every time a new transaction occurs on the blockchain, a record of that transaction is added to every participant's ledger.

There are other ways to buy crypto. For example, some cryptocurrencies use "mining" to help solve complicated equations on the blockchain and offer "miners" payment in the form of crypto for solving those equations. You can also receive it through a marketing promotion on an exchange, which is called an airdrop. These usually occur when a new virtual currency has been added to the exchange.

How Does the IRS Determine Who Owns Cryptocurrency?

The IRS uses a very broad term to determine whether a person owns virtual currency. Using the IRS Notice 2014-21, virtual currency is defined as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." Any asset with these characteristics, "regardless of the label applied, . . . will be treated as virtual currency for federal income tax purposes."

Within this notice, the IRS issued formal guidance on how crypto should be taxed and applied general principles of tax law to determine that virtual currency is property, not currency. This means the crypto taxes you pay are the same as the taxes you might owe when realizing a gain or loss on the sale or exchange of a capital asset.

Do Your Clients Own Cryptocurrency?

If you're wondering whether any of your client's own cryptocurrency, the answer to this question is most certainly "yes." At the time of publication, nearly 15% of Americans own cryptocurrency, which equates to nearly 37 million people. This number is steadily growing as an increasing number of people see the value in owning a decentralized currency.

While many of your customers are cryptocurrency holders, it may be difficult to get them to disclose that they own another form of currency. Many people feel that because cryptocurrency is a commodity and not legal tender, they don't need to include it when filing taxes. This is incorrect, and as a tax professional, you must stress this fact to your clients. Ensure that your clients are aware that all funds, including crypto, must be accurately accounted for at tax time.

People also feel that due to the encrypted nature of cryptocurrency and the anonymity provided by blockchain, the IRS won't be able to track these trading transactions. This just isn't the case. All crypto transactions are recorded in a public ledger that can be viewed by anyone, including the IRS, at any point in time.

15%

OF AMERICANS OWN CRYPTOCURRENCY

Crypto Tax:
What's Considered a Taxable Event?

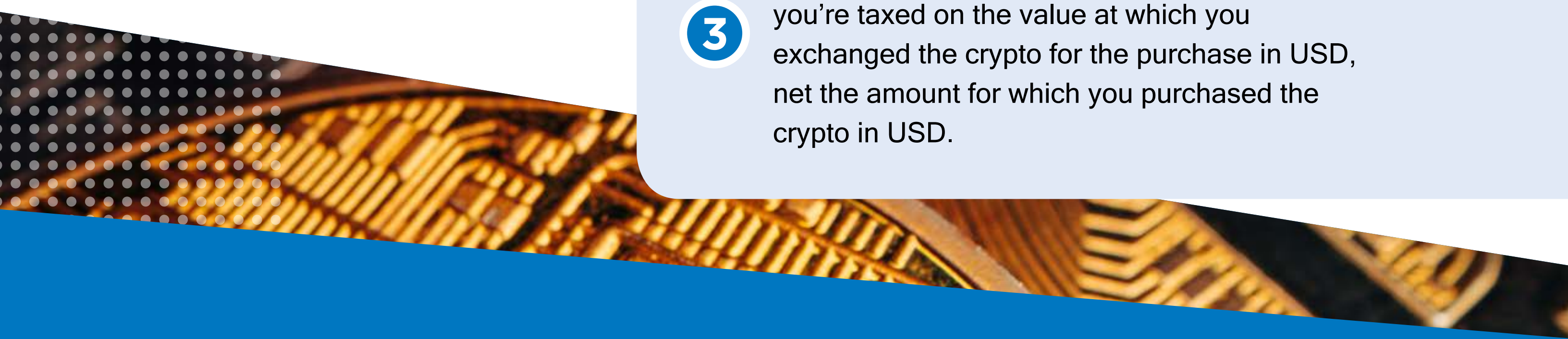
Buying or investing in cryptocurrency are not taxable events. The only time that cryptocurrency can be taxed is when it's sold, exchanged, or used to pay for goods and services.

Activities in which cryptocurrency gains or losses need to be reported on Form 1040 and Form 8949 (Sales and other Dispositions of Capital Assets):

1. When you sell or trade crypto for cash (aka fiat currency), you're are taxed on the value at which you sold it, net the amount for which you purchased it.

2. When you trade crypto for crypto (e.g., trading Bitcoin for Ethereum), you're taxed on the value at which you sold it in USD, net the amount for which you purchased it in USD.

3. When you spend crypto on goods and services, you're taxed on the value at which you exchanged the crypto for the purchase in USD, net the amount for which you purchased the crypto in USD.



There are a few additional scenarios you may need to account for if you've received cryptocurrency as payment, which would need to be reported on Form 1040 as income. Examples include:

- Receiving airdropped tokens resulting from a hardfork.
- Staking or mining cryptocurrency
- *Getting paid in crypto

**It's possible to report crypto as both property and income, depending on how you used it. For example, if you're a gig employee who was paid in crypto and used it to buy coffee at a merchant who accepts crypto as payment, you would be required to report your cryptocurrency income on Form 1040 in addition to filing Form 8949 for your capital gain or loss when disposing of the crypto to buy coffee.*

How to Avoid Crypto Taxes:

What's Not a Taxable Event?

Here are a few examples of instances that wouldn't need to be reported to the IRS:

1. Buying crypto with cash (it's not taxable, but does set your cost-basis).

2. Transferring crypto between any of the wallets or exchange accounts you own isn't a taxable event, provided you don't trade them for another crypto or to fiat currency when you transfer the assets.

3. Gifting crypto (though the gift tax will still apply if you exceed the $15,000 maximum gifting threshold).

4. Donating crypto to a charity or nonprofit organization (which is tax deductible).

> THE IRS ALLOWS YOU TO AMEND PAST YEARS TO INCLUDE CRYPTO TAXES, AND UP TO THREE YEARS TO CLAIM ANY LOSSES OR REFUNDS.

Cryptocurrency & Capital Gains

Because cryptocurrency is considered property it's subject to capital gains tax. Capital gains tax is calculated on cryptocurrency just as it would be on bonds, stocks, and real estate. When you sell a piece of personal property for more than you paid for it, you must pay capital gains tax on the profit.

Cryptocurrency capital gains are calculated by first determining your Cost Basis. Cost basis is the amount of money that you originally spent to acquire your asset. This case reflects the amount of money that it cost you to originally purchase your cryptocurrency. This amount would include costs such as the purchase price of the currency, transaction fees, and brokerage commissions.

Next, you need to calculate the Fair Market Value at the specific time of the trade. This is the value that the cryptocurrency was worth when it was sold or traded.

To determine the Capital Gains amount, subtract the purchase price from the sold price, and the difference will be your taxable capital gains.

It's also important to remember that coin-to-coin trades are taxable events and must be considered when determining capital gains. For example, say you were to purchase $100 worth of Bitcoin, including all transaction and brokerage fees, and that purchase got you 0.01 Bitcoin. If you were to trade this for an Ethereum a few months later, you would need to determine the fair market value of the Bitcoin at the time of the trade. If the Bitcoin was worth $150, you would subtract that from your initial purchase price and would have a capital gains amount of $50 to declare for tax purposes.

Another difficulty with calculating capital gains on cryptocurrency is the fact that many holders are making frequent trades. It can be complicated to track each trade and the capital gains earned from each one. Fortunately, numerous software programs can help with this, making it much easier to determine taxation amounts.

Crypto Capital Gains Tax Rate

The amount of capital gains that must be paid are based on how long the cryptocurrency is held. Depending upon the income tax bracket, cryptocurrency that's held for a year or less are recognized as short-term gains and taxed at ordinary income tax rates. Meanwhile, crypto that's been held for at least one year and one day are considered long-term capital gains and taxed at a rate of 0%, 15%, and 20% depending upon the tax bracket.

Here are the 2021 US federal income brackets for short-term capital gains.

2021 Income and Short-Term Capital Gains Brackets

RATE	FOR UNMARRIED INDIVIDUALS	FOR MARRIED INDIVIDUALS FILING JOINT RETURNS	FOR HEADS OF HOUSEHOLDS
10%	$0 to $9,950	$0 to $19,900	$0 to $14,200
12%	$9,951 to $40,525	$19,901 to $81,050	$14,201 to $54,200
22%	$40,526 to $86,375	$81,051 to $172,750	$54,201 to $86,350
24%	$86,376 to $164,925	$172,751 to $329,850	$86,351 to $164,900
32%	$164,926 to $209,425	$329,851 to $418,850	$164,901 to $209,400
35%	$209,426 to $523,600	$418,851 to $628,300	$209,401 to $523,600
37%	$523,601 or more	$628,301 or more	$523,601 or more

Here are the 2021 US federal capital gains tax rates per income tax bracket These rates apply to long-term capital gains (crypto or other assets held for at least one year and one day).

2021 Long-Term Capital Gains Brackets

RATE	FOR UNMARRIED INDIVIDUALS, TAXABLE INCOME OVER	FOR MARRIED INDIVIDUALS FILING JOINT RETURNS, TAXABLE INCOME OVER	FOR HEADS OF HOUSEHOLDS, TAXABLE INCOME OVER
0%	$0	$0	$0
15%	$40,400	$80,800	$54,100
20%	$445,850	$501,600	$473,750

Cryptocurrencies and Losses

Unfortunately, not all crypto trades incur a profit; in fact, many people are experiencing losses from this volatile market. The IRS is aware of this and allows cryptocurrency investors to claim deductions on these losses leading to lower tax liability and possibly even a tax refund.

> ***Since October 2020, nearly 7,000 people reported losses due to crypto scams, according to the Federal Trade Commission. The median loss was $1,900 per investor.***

Because cryptocurrency is considered an asset by the IRS, every taxable event, including losses, must be reported on Form 8949. A loss occurs when you sell or trade cryptocurrency for less than what you purchased it for, and these losses can help offset your capital tax gains.

Many crypto traders take part in something called crypto-tax loss harvesting. This strategy is put in place when an investor has acquired significant capital gains. It works by incurring a loss on investments that aren't performing well, which balances out the gains and losses of the trader's overall investments.

The IRS will allow for a maximum deduction of up to $3,000 in losses per year when submitting taxes. If the amount of the losses exceeds this maximum amount, the remainder can be carried forward to the following year and used to offset capital gains in the future.

Losses can help offset capital tax gains.

Cryptocurrency Loss Types

There are a few different types of cryptocurrency losses that are worth taking note of:

HACKS AND THEFT

As with any online transactions, hacks and theft can occur with cryptocurrency transactions as well. When a loss occurs with a crypto investment, they are not considered personal casualty losses.

According to IRS tax code 165(c)(ii), crypto investments define profit transactions. Because of this fact, crypto losses that result from theft or hacking are deemed complete taxable losses for income tax purposes. Complete losses of this type must be claimed on IRS form 8949 as zero ($0) proceeds.

PONZI SCAMS

Ponzi schemes are a type of fraud that lures investors in with the promise of earning even greater profits. These schemes are becoming more prevalent for online investors, and those with cryptocurrency holdings aren't immune.

To claim losses incurred due to a Ponzi scam, an investor must prove to the IRS that they dealt with someone who was charged and indicted for Ponzi scamming. Tax losses from Ponzi scams are treated as itemized deductions. Therefore, they aren't subject to the $3,000 capital loss restriction set up for capital losses. The amount contributed to a Ponzi scan can be deducted from a filer's taxable income. This type of deduction is also known as the "Bernie Madoff" deduction.

Preparing & Filing Taxes for Cryptocurrency

While preparing your taxes to file for cryptocurrency may seem like an overwhelming task, it doesn't have to be. Four simple steps can be followed to make year-end tax prep a breeze.

1

MAINTAIN A DETAILED RECORD OF ALL CRYPTO TRADES & ACTIVITY.

The IRS requires all crypto investors to maintain accurate records of their crypto trading, purchases, and sales, including activities such as interest loans and airdrops.

Most high-profile crypto exchanges or sites have tax reporting features that instantly generate these reports making record keeping a much simpler task.

2

CALCULATE YOUR GAINS & LOSSES.

When you have access to all your crypto transactions for the year, you can easily calculate gains or losses, or you can insert this information into the proper software.

3

COMPLETE IRS FORM 8949, THEN ATTACH IT TO SCHEDULE D.

The IRS Form 8949 represents the specific form used for reporting capital gains and losses for cryptocurrencies.

Schedule D represents the main tax form for the reporting of overall capital gains or losses.

According to the IRS, all crypto earned as income must be reported on Schedule 1 of the main taxpayer's form 1040.

Self-employment earnings from crypto must be reported on Schedule C.

4

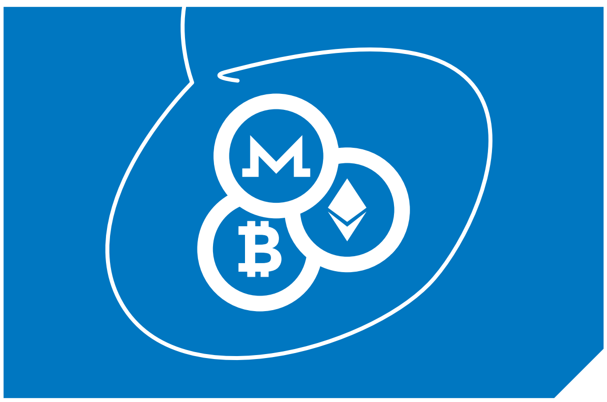
FILE THE RETURN.

After completing the required forms, pay the tax and file the return.

DONE!

What Does the Future of Cryptocurrency Look Like?

Nearly 16% of men invest in crypto, versus 7% of women, according to a CNBC survey.



The concept of cryptocurrency is still new. While many people are still in the early stages of educating themselves on the idea of digital currency, many are diving in, feet first.

Today, the most common crypto investor is a white, middle-aged male who earns a six-figure income or greater, although many women are showing interest. The majority of these investors are still dabbling in crypto, but their holdings are increasing substantially as trust in decentralized currency continues to grow. Most crypto investors are familiar with Bitcoin, while only 38% are familiar with Ethereum.

As knowledge of cryptocurrency spreads, it's estimated that the number of investors in this virtual currency will double within the next year, making it vital for all tax professionals to have a solid grasp of cryptocurrency and its tax implications.

It's also essential that your clients know where to turn to get help when dealing in the often-muddied world of cryptocurrencies and the IRS. That's where Johnson Nathaniel can help. We can help you market your services through innovative online solutions directed towards those who need your help the most - the cryptocurrency investor.

FAQs

Q: How does the IRS treat virtual currency?

A: Virtual currency is taxed like other assets, such as gold or stock investments. Therefore, crypto is considered property for tax purposes.

Q: Is virtual money considered as currency for tax purposes?

A: No. Virtual money is not yet recognized as a currency that creates a taxable foreign exchange gain or loss.

Q: Do you have to include gross income in crypto's fair market value (FMV) when it's received as payment for services or products?

A: Yes. If you receive virtual cash in exchange for services or products, you must base gross proceeds on the FMV of the crypto.

Q: How is the Fair Market Value (FMV) for crypto figured?

A: Virtual currency transactions are recorded in US dollars for tax purposes. Therefore, a taxpayer must establish the FMV of a virtual currency in US dollars as of the payment date.

Q: Is there a gain or loss when an investor exchanges virtual currency for real property?

A: Yes. If the adjusted basis in the crypto surpasses the FMV of the property, it represents a taxable gain. Otherwise, it's considered a loss, for tax purposes, if the property received is valued less than the virtual currency.

Q: What constitutes the gross income of a taxpayer who "mines" virtual currency?

A: The fair market value (FMV) of the mined currency is used, as of the date of receipt, for income tax purposes.

Q: When selling or exchanging virtual money, what sort of gain or loss does a taxpayer realize?

A: The gain or loss depends on whether the taxpayer owns the virtual currency as a capital asset.

1. He or she will realize a gain or loss for an exchange or sale of crypto that's considered a capital asset. A capital asset is an investment, such as a stock or bond.
2. An ordinary gain or loss is normally realized on virtual currency that's not held as a capital asset. Examples of property not treated as capital assets include property offered for sale or a company's inventory.

Q: Is someone who "mines" virtual money for a living subject to self-employment tax on the profits?

A: If mining the currency is part of a business or trade and the taxpayer does not do the work as an employee, his or her net earnings are subject to the payment of self-employment tax.

Q: Is money virtually earned by an independent contractor for a service considered self-employment income?

A: Yes. The fair market value (FMV) for the virtual currency received for contracting services is measured in US dollars when the money is received and therefore is taxable.

Q: Is the crypto and employer pays considered taxable wages?

A: Yes. The fair market value (FMV) currency, converted to US dollars, is subject to federal withholding.

Glossary

Airdrop: A transfer of free cryptocurrency from a crypto project into users' wallets. This is usually done as a form or promotional marketing for a new type of virtual currency.

Bitcoin: When the B is capitalized, it represents the overarching concept of Bitcoin: The technology, the community, the protocol, and the software. When it's not capitalized, it's describing a unit of currency.

Blockchain: A universal public ledger of bitcoin transactions till date.

Crypto exchange: A platform on which you can buy and sell cryptocurrency.

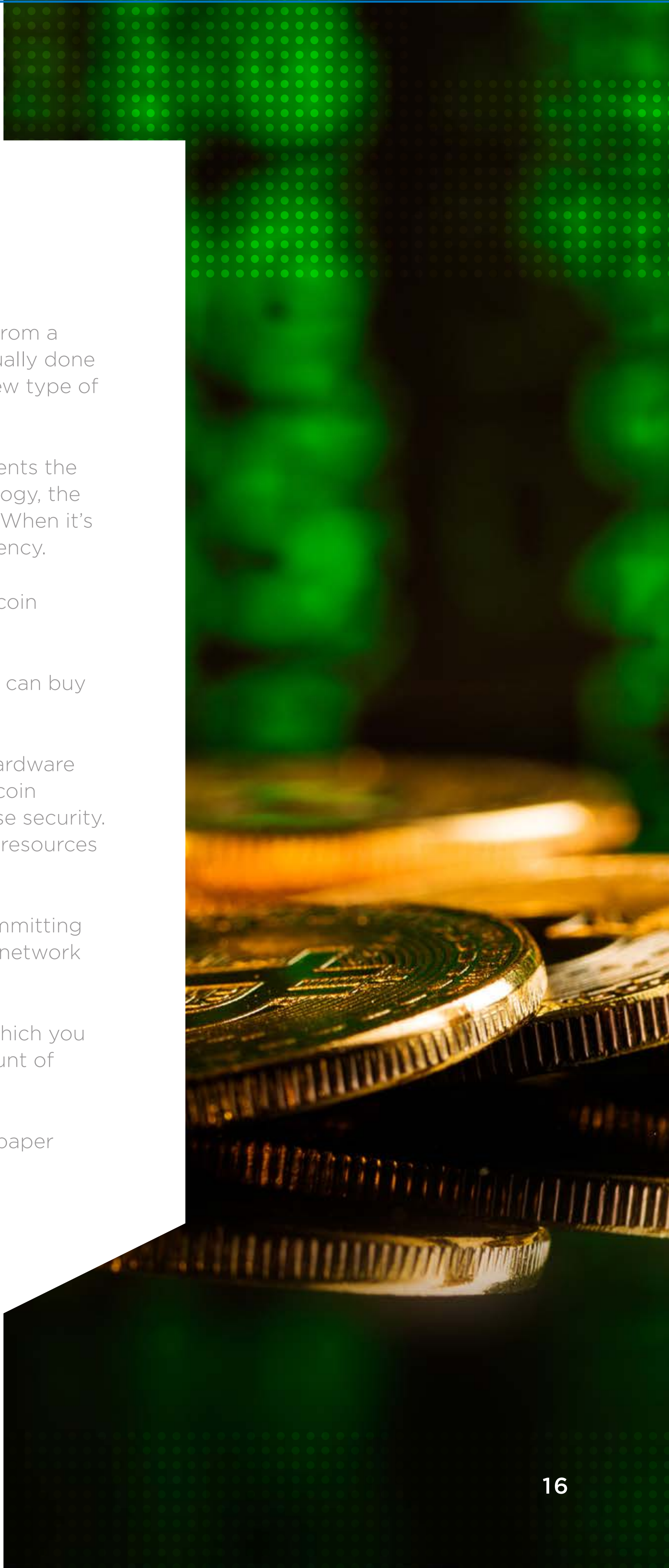
Crypto mining: The process of computer hardware doing mathematical calculations for the Bitcoin network to confirm transactions and increase security. Users who use their computers and/or rent resources for mining are called miners.

Crypto staking: A process that involves committing your crypto assets to support a blockchain network and confirm transaction.

Crypto-tax loss harvesting: A strategy in which you sell crypto held at a loss to lower your amount of reported capital gains.

Fiat currency: A regulated and centralized paper currency of any nation.

Hardfork: A software update or an update on the blockchain protocol that is not backward compatible.



Summary

Decentralized currency is becoming increasingly popular among investors, and the IRS has taken notice. As the number of cryptocurrency investors continues to grow exponentially, the need for educated and knowledgeable tax professionals continues to grow as well. Knowing how to properly handle capital gains and losses, along with all of the technical jargon that goes along with crypto is vital to ensure the financial health of your clients. However, doing so while complying with IRS regulations can be a challenge.

Trading cryptocurrency can offer a whole new world of excitement, but along with it can come a whole host of new challenges. As a tax professional, it's up to you to stay current and create an easy and seamless tax season for all your investors.

It's up to you to stay current.

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