TAXES TODAY

eNewsletter for Tax Professionals

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Cryptocurrency: The Tax Essentials

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Today, I'm thinking about the future. When it comes to tax planning, that's the whole point, right? One man who has helped us move into the future is technological innovator and investor Bill Gates. He's clear with his opinion on the future of money:

Indeed, cryptocurrency, a popular type of digital currency that sprang to the scene with the launching of Bitcoin in 2009, certainly looks to be huge part of our future.

And with the IRS announcing in 2018 its concerns over significant underreporting of income generated by cryptocurrency, it appears **the IRS plans to strictly monitor and enforce the compliance of cryptocurrency transactions.**

Understanding this, I felt it was important to focus our 7.12 Taxes Today on the federal tax rules governing cryptocurrency.

The IRS first addressed the tax treatment of cryptocurrency in Notice 2014-21. The most important takeaways from this notice are the following:

1. **Cryptocurrency is treated as property (not currency).** As such, tax rules that are applicable to property generally apply to cryptocurrency transactions.
2. **If a taxpayer receives cryptocurrency for payment of goods or services, they must include in ordinary income the fair market value of the cryptocurrency received.** The fair market value is the cryptocurrency's value translated to U.S. dollars at time of receipt.*
3. **The gain/(loss) a taxpayer realizes for the sale of cryptocurrency receives identical treatment as other capital assets, such as stocks.** Therefore, any gain from the disposition of cryptocurrency is treated as investment income and the sales are reported on Form 8949. For taxpayers that

purchased Bitcoin (or another cryptocurrency) near the market high towards the end of 2017, this is clearly unfortunate, as they are limited to using these losses to offset capital gains (and up to $3,000 of ordinary income).

*Example: Tina paints a house and the market value of this service is $4,000. If the homeowner chooses to pay Tina with Bitcoins in an amount worth $5,000, because she is being paid in property, then $5,000 is what Tina must include in her tax return as income.

In addition to being purchased and sold, cryptocurrency can also be created by an esoteric process called "mining." In the very simplest terms, this process creates additional cryptocurrency, and the individual creating it receives a share.

The cryptocurrency the individual "mining" receives is taxable as ordinary income at the fair market value of the cryptocurrency at the time of receipt.

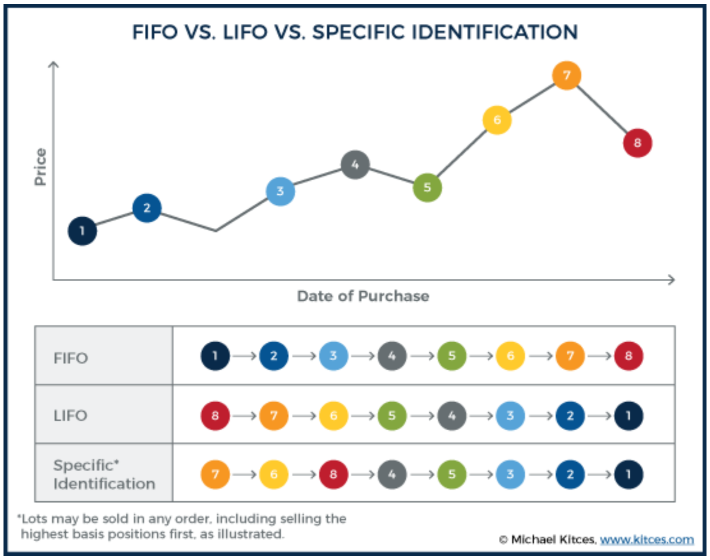
Let's take a look at a simplified example:

Through "mining," Nick creates additional Litecoins (a popular cryptocurrency). In exchange for this "mining," Nick receives 5 Litecoins himself, each valued at $10,000. This payment creates $50,000 of ordinary income to Nick, which is also now the basis in his Litecoin. If Nick then sold his 5 Litecoins two years later for a total of $70,000, he will realize $20,000 of long-term capital gains at the time of disposition.

Note: if Nick's "mining" constitutes a trade or business, he is subject to self-employment tax on the income derived from this activity.

What accounting method is used at disposition?

The default method of accounting, consistent with sale of a stock, is **first-in, first-out (FIFO)** Under, certain circumstances, **specific identification** is allowed. And while utilizing specific identification has the potential to meaningfully reduce the recognized gain on cryptocurrency transactions, using this method often proves challenging because cryptocurrency can be divided into an infinite number of "parts," which makes identifying an individual lot (or group of lots) difficult.



Can you avoid paying taxes by exchanging one appreciated cryptocurrency for another?

No. While in the past, taxpayers have argued that cryptocurrency-to-cryptocurrency trades are classified as 1031 like-kind exchanges, the Tax Cuts and Jobs Act (TCJA) limited 1031 like-kind exchanges to real property.

Can cryptocurrency be donated?

Yes. Similar to donating stock, the tax deduction is equal to the fair market value of the donated cryptocurrency. The taxpayer will also get the dual tax benefit of not realizing any capital gains on the cryptocurrencies appreciation. *Note: Cryptocurrency must be held for more than one year to be eligible for this particular deduction strategy.*

Any other tax planning opportunities with cryptocurrency?

Understanding the volatile nature of cryptocurrency and the dramatic pullback in this particular market segment in 2018, many taxpayers holding cryptocurrency have unrealized losses. Like stocks with embedded losses, these losses can be used to offset other capital gains. Harvesting these losses, especially given wash sale rules have not yet been established for cryptocurrency, can be especially impactful.

A more familiar way for us to discuss the future – in particular, our personal financial futures – has to do with saving for retirement with IRAs. **For millions of California state workers, saving for retirement just got easier.**

As of July 1, workers at California companies with no employer-sponsored retirement plan may be able to contribute part of their paycheck to an individual retirement account (IRA) through a new state-sponsored retirement savings program called **CalSavers**.

CalSavers requires eligible employers without a company-sponsored retirement plan to set up Roth IRAs for employees, to which they can contribute through automatic payroll deductions.

To read more about CalSavers, check out the article, "It's about to get easier for millions of California workers to save for retirement.

We are here to help.

*As always, please feel free to reach out and call (**916-405-9166**) or email (**spitchford@towerpointwealth.com**) with any questions, thoughts, or needs you may have. At Towerpoint Wealth, we are happy to be a direct and no-strings-attached resource for you.*

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