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Cryptocurrency – An Introduction to Common Terms (and Taxation)

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Once an opaque and misunderstood asset class, cryptocurrency has now fully broken into the mainstream and is becoming increasingly prevalent in the modern investor's asset allocation. From mayors and athletes receiving their salaries in cryptocurrency, to major sporting venues being named after cryptocurrency companies in historic sponsorship deals, cryptocurrency increasingly looks like it's here to stay.

We thought it might be helpful to our clients and friends to provide an introduction to Cryptocurrency, and more importantly, address the tax attributes that will impact you when filing a US tax return. Please keep in mind that we aren't making recommendations for you to invest or not in this asset class, but rather educating you on some of its fundamentals.

What is Cryptocurrency?

Cryptocurrency is a decentralized digital representation of value, that functions as a unit of account, a store of value, and a medium of exchange. It's not issued or backed by a government and eliminates the need for transitional intermediaries like banks and governments to make financial transactions.

What are some key terms?

Types of Cryptocurrencies – Some of the most popular are Bitcoin, Ethereum, Litecoin, Dogecoin and Bitcoin Cash.

Blockchain – A digitized public ledger that facilitates secure peer-to-peer transactions without the need of a regulated third party.

Block – A blockchain is made up of blocks that hold historical records of all cryptocurrency transactions until full.

Cryptocurrency exchange – A marketplace where you can buy and sell cryptocurrencies, some examples are Coinbase, Gemini, Kraken and KuCoin.

Wallet – An app that allows a place to securely keep your digital assets.

Private Key – Acts as a password to access your wallet.

Initial Coin Offering – A company can create a new cryptocurrency and put some of the initial batch of coins up for sale to build a user base.

Airdrop – Free tokens sent to wallets for in return for a social media post or marketing of the virtual currency.

Hard Fork – When a single cryptocurrency splits in two. This may result in the creation of a new cryptocurrency on a new ledger in addition to the legacy cryptocurrency that runs parallel with the original.

How is Cryptocurrency taxed?

Cryptocurrency is treated as property for federal tax purposes. The gain or loss is based on the difference between the taxpayer's basis in the property and its fair market value ("FMV"). A taxable transaction occurs every time cryptocurrency is used for the exchange of goods or services. Yes – that is right – every time it is exchanged, there is a reportable transaction marking a gain or loss on the exchange.

Some tax principles that apply to virtual currency are:

- A payment using virtual currency is subject to information reporting to the same extent as any other payment made in property.
- Payments using virtual currency made to independent contractors and other service providers are taxable, and self-employment tax rules generally apply. Normally, payers must issue Form 1099-MISC.
- Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2 and are subject to federal income tax withholding and payroll taxes.
- Certain third parties who settle payments made in virtual currency on behalf of merchants that accept virtual currency from their customers are required to report payments to those merchants on Form 1099-K, *Payment Card and Third-Party Network Transactions*.
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
- Airdrop marketing giveaways are taxed as ordinary income, valued on the date the cryptocurrency is received.
- When cryptocurrency goes through a hard fork, the new forked cryptocurrency received is taxed as ordinary income.
- Gifting of cryptocurrency falls under the gift exemption rules and gifts up to $15,000 per recipient are not subject to gift tax and the recipient will inherit the donor's tax basis.
- Cryptocurrency does not qualify as like kind property, in part because it is not real estate. Exchanges of one cryptocurrency for another is therefore a taxable event.

- Since cryptocurrency is property and not cash or securities, FBAR & FATCA generally should not apply unless the cryptocurrencies are exchanged for foreign currency and the FBAR and FATCA thresholds are met.

Which accounting method to use for determining basis for purposes of calculating a gain or loss on disposition?

Since cryptocurrency is a considered a capital asset, the basis will need to be accounted for.

The default method for the IRS in determining basis is first in, first out (FIFO). The first coin purchased is the first coin that is counted for a sale.

Should you wish to use a different basis, there is currently no need to elect a new method, but IRS guidelines request that you be sure to keep detailed records that can identify the method you are choosing. Alternative basis methods are as follows:

Last-in first-out, the last coin acquired will become the first coin that you sell.

Highest-in, first-out (HIFO), you sell the highest cost base first. Assuming adequate records are kept, this will be the most advantageous method of tax accounting for clients.

What technology does SKP have to support your Cryptocurrency needs?

For those with more complex crypto activity spanning multiple accounts and wallets, SKP can provide access to a data and software solution that assists with data collection, resolves industry discrepancies in determining FMV, and delivers accounting flexibility around FIFO, LIFO, and HIFO This lowers the burden of manually sorting through transactions in the absence of exchange-provided 1099s.

What resources have the IRS provided to guide accountants in accounting for Cryptocurrency and understanding the tax impact of Cryptocurrency?

The IRS and FASB have provided us with several guides including the following:

- Notice 2014-21
- Revenue Ruling 2019-24
- IRS FAQ on Virtual Currency Transactions

What's next?

Are you already trading Crypto and not sure how it will impact your tax return, or business? Reach out to our professionals at SKP to help guide you. The last thing you want is an unplanned tax bill, or unexpected accounting treatment for your Company's financial statement. We are here to help.