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gurus, cyber criminals, and those who trade on the black market, cryptocurrency ...

Dave DuVal • Mar. 19, 2018

This past year, cryptocurrencies, particularly Bitcoin, saw a meteoric rise in popularity and usage. Once considered something that is only utilized by cutting-edge tech gurus, cyber criminals, and those who trade on the black market, cryptocurrency took residence on Main Street America in 2017. Hopefully, your tax organizer has a couple of questions about cryptocurrency this year. At minimum, we as tax practitioners should be asking all our clients if they invested in or received any income in cryptocurrency.

But do you know what to do if that answer is "yes"? What do we do if some of our clients have invested in Bitcoin or started using it to pay for goods or services like groceries, movie tickets and clothing? Although your first instinct may be to place the return in the extension drawer, lock your office and place a sign on the front door that reads "Gone Fishing Until July," the situation is not that dire. In fact, it may be more manageable than you first thought.

Cryptocurrency is a form of convertible virtual currency. Because those who accept it agree upon its value, it can be used as a medium of exchange for goods, services, or fiat currency. Although it can be used like any other currency for buying and selling purposes, it does not have "legal tender" status in the United States. In IRS Notice 2014-21, the IRS stated that for U.S. tax purposes, cryptocurrencies like Bitcoin or Ethereum are to be treated as property for tax purposes, not as currency. Some countries, like Japan, treat Bitcoin as legal tender, while others may ban its use entirely.

Since issuing Notice 2014-21, however, the IRS has been silent about the tax issues surrounding Bitcoin and other cryptocurrencies. All the general tax principles that apply to property transactions will apply to cryptocurrency transactions. This means that using virtual currency may be similar to bartering transactions. For example,

rates and use the same exchange on a consistent basis.

One area of Notice 2014-21 is clear: the IRS may impose such penalties as the accuracy-related penalties under Section 6622, and information reporting penalties under Sections 6721 and 6722 when taxpayers are using cryptocurrencies. On the other hand, the IRS stated that penalty relief may be available if the taxpayer can show reasonable cause for the error.

In addition to possible penalties for underreporting income from cryptocurrency transactions, the federal statute of limitations may be extended from three years to six years if the omission of income is more than 25% of total gross income reported on the taxpayer’s return. Remember, the extension of the statute of limitations will apply to all items on the return and not just the income that was omitted. For some states, the statute of limitations can be 20 years or more for substantially underreported income.

For investors, the character of the gain or loss depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Gains and losses from the exchange of virtual currency are reported on Form 8949 for investors and treated as any other capital gain or loss transaction would be. Short-term gains are treated as ordinary income, long-term gains receive capital gains tax treatment, and losses are limited to $3,000 a year.

Some tax professionals have speculated that the IRS may treat investing in Bitcoin as a collectible subject to the 28% capital gains rate, but without guidance from IRS, this is uncertain. Another ambiguous area of cryptocurrency and taxation are the Mark-to-Market rules of Code Sections 465 and 1256. The tax code allows day traders in securities to make a mark-to-market election on their income tax return when appropriate. However, Notice 2014-21 is silent about the mark-to-market election for those taxpayers who day trade in Bitcoin or another cryptocurrency.

When virtual currency is exchanged for other personal property (e.g. movie tickets,

for personal consumables like food, entertainment, personal property or services is deductible on Schedule D. It may depend on the nature of the cryptocurrency before it was traded. If the underlying Bitcoin was held for investment purposes, then any losses on the exchange may be deductible. On the other hand, if the underlying cryptocurrency was not held for investment purposes, then any gains would be taxable and any losses not deductible. And it is up to the taxpayer to show they have deductible losses.

While the popularity and use of cryptocurrencies rose dramatically in 2017, the current downward slide of Bitcoin leaves many of us wondering about their future. Whether it comes to a bad ending now or never, we as tax professionals need to be prepared to report our clients' actual transactions correctly. We hope that the IRS will be more forthcoming with additional guidance soon.

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Digital Currency