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or providing goods or services, the U.S. fair market dollar value of the cryptocurrency earned must be recorded as of the date of receipt. This fair market value ...

Dave DuVal • Jul. 31, 2018

Now that the rush of tax season is in our rearview mirrors, and we've had an opportunity to see the morning sun after a good night's rest, it is time to start considering how we are going to tackle those extended returns where our clients utilized cryptocurrency in their small businesses. More and more businesses are accepting cryptocurrency as a form of payment. Additionally, new businesses are forming around the world of cryptocurrency such as bitcoin kiosks businesses and cryptocurrency bill paying services.

During February, some of our clients may have received notifications from Coinbase (one of the most popular U.S. based cryptocurrency exchanges), regarding their 2013-2015 returns. Complying with the "Notice of Narrowed Summons Request for Enforcement" from the IRS, on February 23, 2018, Coinbase issued notifications to approximately 13,000 taxpayers that the following information about their Coinbase accounts were forwarded to the IRS: name, ID, date of birth, address, and most notably, their historical transaction records for the years 2013-2015. The taxpayers whose records were transferred to the IRS have one thing in common: at least one of their cryptocurrency transactions (whether it was a buy, sell, send or receive) was $20,000 or more during the aforementioned years.

Along with the information the IRS receives from the Coinbase narrowed summons, the IRS is utilizing blockchain tracing and analysis software from Chainalysis. Given the IRS's enforcement actions and the continued rise in the use of cryptocurrency in small business, it's important tax practitioners understand the tax treatment fundamentals of this complex area.
Although cryptocurrency is considered a convertible virtual currency (meaning it is

interchangeable with fiat currency for buying and selling purposes), it is not

additional reportable gain or loss when the cryptocurrency is used to pay for the business's operating expenses or converted into U.S. dollars. If the fair market value of the property or service received in exchange for the cryptocurrency exceeds a taxpayer's adjusted basis in the cryptocurrency, the taxpayer has a reportable taxable gain. Conversely, a taxpayer will realize a loss if the fair market value of the property received is less than the adjusted basis of the cryptocurrency.

Mining for bitcoins is considered a service and not property that is produced. When a taxpayer receives bitcoin for mining a block or confirming a transaction, the gross income will be equal to the fair market value in U.S. dollars at the date the cryptocurrency is received.

On March 18, 2013, FinCEN (Financial Crimes Enforcement Network) issued guidance to businesses that engage in cryptocurrency stating that businesses that issue, redeem, or exchange virtual currency are considered money transmitters. It does not matter if the cryptocurrency is exchanged for other cryptocurrency, foreign currency, or U.S. dollars; these companies are considered money service businesses and may need to register with FinCEN. Those who simply use cryptocurrency are not considered money service businesses, nor are miners who obtain cryptocurrency for their own benefit. Businesses that do not register may face penalties. To register as a MSB, businesses (including sole proprietorships) must file FinCEN Form 107.

Businesses that utilize bitcoin or other virtual currency are required to keep detailed records of the fair market value in U.S. dollars as they receive each unit of cryptocurrency. They also need to set-up and maintain an inventory valuation method, such as FIFO, LIFO, or another alternative valuation method for when the cryptocurrency is either traded for U.S. dollars or used to pay for expenses associated with their business. Some virtual currency websites have suggested taxpayers may use alternative valuation methods such as High Cost First Out, Highest Price First

Out, Lowest Cost First Out, Lowest Price First Out, and Specific Identification

horizon. One thing is for certain- documentation will be the key to successfully representing a taxpayer with cryptocurrency investments, businesses, or prospecting hobby income.

Due to the complexities and nuances surrounding cryptocurrency transactions, it is vitally important for taxpayers to keep separate and meticulous records of each transaction. This includes devising a transaction log that includes pertinent information that will be needed to accurately prepare income taxes for that year. Examples of information that should be included in the log are:

- Dates the cryptocurrency was purchased, mined, or received;
- The number of cryptocurrency units received, sold, or exchanged;
- The value of the cryptocurrency in U.S. dollars as of the date of receipt or exchange;
- What property was received (including fiat currency);
- The cost and the purpose for the transaction.

Keep in mind that transaction logs should also reconcile. Sometimes cryptocurrency users may have to use several wallet addresses to purchase an item or complete a transaction. A "wallet" is a cryptocurrency wallet, which is a software program that stores private and public keys. The wallet interacts with various blockchains to enable the users to send and receive digital currency and monitor their balance. If this is the case, the log should include the transaction details for every wallet. To substantiate the log, taxpayers should include any corresponding receipts, invoices, mining pool statements and copies of the blockchain transaction. For taxpayers who do not want to devise their own transaction log, there are various cryptocurrency software programs on the market that will create transaction logs.

Since there can be a variance in the valuation of cryptocurrency between exchanges, taxpayers should research which cryptocurrency exchange will serve their purposes the best and be consistent in using that same exchange when determining

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Digital Currency