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DIGITAL CURRENCY

Decrypting Tax Season: How to Understand Cryptocurrency Taxation

Reporting cryptocurrency transactions to the IRS can be a complicated process, and while the IRS has put together a helpful FAQ, the Illinois CPA Society encourages taxpayers to partner with a CPA ...

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Cryptocurrency investing and spending was a hot topic again in 2021 as the likes of bitcoin, dogecoin, ether, and others set record high valuations and their commercial use became more widely accepted—think Tesla accepting bitcoin and dogecoin as forms of payment for its electric vehicles, and many high-profile athletes and public figures taking their salaries in cryptocurrencies. But as cryptocurrencies catch the attention of more investors and consumers, they're also drawing more scrutiny from regulators—including the IRS. In fact, as we head into tax season, the IRS prominently asks on Form 1040, "At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?"

So, as taxpayers prepare their 2021 tax returns, here are the top things to remember when following the IRS' guidance for reporting taxable cryptocurrency purchases, sales, trades, and transactions:

Generally speaking, buying cryptocurrency isn't a taxable event. If you hopped aboard the cryptocurrency train in 2021 and bought any cryptocurrencies but didn't trade or spend them, you probably don't owe any taxes on them. So far, the IRS has outlined the following taxable situations:

- Selling your cryptocurrency for cash.
- Trading one cryptocurrency for another.
- Using cryptocurrency at a merchant as payment, including via a cryptocurrency-based debit card.
- Receiving airdropped tokens resulting from a hard fork.
- Staking or mining cryptocurrency.
- Being paid in cryptocurrency.

In other words, if a taxpayer simply purchased a cryptocurrency and continues to hold it in their brokerage account or digital wallet and didn't sell, trade, or exchange it, there's likely no tax consequence or additional reporting required. Gifting or donating cryptocurrency and transferring it between exchanges or brokers are also non-taxable events.

Cryptocurrency is subject to capital gains tax. In the IRS' eyes, cryptocurrencies are property and are generally taxed like stocks, so when a cryptocurrency is spent or traded, those are taxable transactions, and a taxpayer must report the capital gains or losses on their tax return. The capital gain or loss is based on the difference between the acquisition cost and the sale proceeds and the holding period.

When you're paid with cryptocurrency, it's treated as income at the fair market value of the digital asset on the date you receive it. As cryptocurrency becomes more commonplace, so too is being compensated with it for goods and services. Employers who use cryptocurrency for wages or to pay for goods and services must still report employee earnings on W-2 forms, withhold the same amounts as if paying wages in dollars, and convert the value of the cryptocurrency to dollars on the date of payment. Self-employed taxpayers who accept cryptocurrencies for their goods or services must track the transaction dates and values in dollars as the transactions occur to report the income and capital gains or losses when filing their tax returns.

Careful tracking is key. It's up to taxpayers investing and transacting in cryptocurrencies to track any possible taxable activities and the fair market value of those transactions. Unlike traditional stock investments, 1099-B forms aren't required to be issued to cryptocurrency investors by exchanges. As such, it's recommended to keep a detailed log of all cryptocurrency transactions throughout the year to ensure accurate reporting to the IRS during tax time.

Reporting cryptocurrency transactions to the IRS can be a complicated process, and while the IRS has put together a helpful FAQ, the Illinois CPA Society encourages taxpayers to partner with a certified public accountant (CPA) for assistance with accurately reporting cryptocurrency transactions all year long and properly filing their tax returns during tax season. The Illinois CPA Society's free "Find a CPA" directory can help taxpayers find the trusted, strategic advisors that are right for them based on location, types of services needed, and languages spoken. Find a CPA at www.icpas.org/findacpa.

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