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Cryptocurrency Tax Tips, Until Tax Relief Passes: Expert Blog

EXPERT BLOG

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The IRS says Bitcoin and other digital currencies are considered property for tax purposes. That may sound simple, but it really isn't, and that complexity can have far-reaching effects. For example, if you use Bitcoin to pay for something worth $500, what does the IRS say? You just sold your Bitcoin. You have gain or loss on the sale, depending on how much you paid for the Bitcoin, and how much it is worth when you sold (presumably about $500).

Is that gain ordinary, or capital; short or long term? It all depends on the circumstances, so buying that $500 item with Bitcoin can get messy. Meanwhile, the IRS is trying to crack down on reporting, since very few people seem to be reporting their transactions. The IRS is using John Doe summonses to obtain data on Bitcoin and other digital currency users, as recently publicized by the Coinbase case.

IRS hunting for cheats

The IRS is even hunting Bitcoin user identities with software. This may make you worry that you could owe taxes, penalties and interest. In extreme cases, the IRS could pursue cases criminally. However, a bipartisan bill, "The Cryptocurrency Tax Fairness Act of 2017," was introduced in the House by Rep. Jared Polis (D-Co) and Rep. David Schweikert (R-Az). It calls for a tax exemption for transactions under $600.

If it passes, it would provide a world of tax relief for smaller, day-to-day transactions. Remember, the IRS announced in Notice 2014-21 that Bitcoin and other digital currency is property for tax purposes, not currency. Every time you use digital currency, a taxable event is occurring.

A payment made using virtual currency is subject to Form 1099 reporting too. Wages paid to employees using virtual currency are taxable, must be reported on a Form W-2, and are subject to federal income tax withholding and payroll taxes. That can mean paying the employee some cash and some Bitcoin, and taking federal withholdings from the cash payment.

Virtual currency payments to independent contractors are taxable, and payers must issue Form 1099. This form must be filled out using Bitcoin's value in dollars at the time of payment, meaning that valuation swings can have brutal tax consequences. So, under the proposed tax bill, any transaction under $600 would be completely exempt.

Passage of this legislation would mean not having to worry about keeping track of gains on small transactions. Plus, the proposed law calls for the Treasury Department to provide guidelines for reporting on profits and losses tied to digital currencies. As the IRS and Coinbase continue to spar over user records, it is worth remembering that the IRS used a John Doe summons to get names of Swiss bank account holders from UBS.

Mr. John Doe

As a result, offshore banking changed forever, with all other Swiss banks eventually having to release records. In the IRS offshore bank cases, the IRS ended up collecting over $10 billion. Some people are saying that IRS efforts on digital currency might end up following the same kind of pattern.

In that sense, for digital currency users and investors, change is coming. The IRS claims that only 802 people declared a capital gain or loss related to Bitcoin in 2015.

This suggests that the bulk of Bitcoin transaction are not reported. In 2017, there may be more transactions and more awareness, and more fear. The estimated value of the cryptocurrency economy is something on the order of $162 billion.

Enforcement

With millions of transactions and the meteoric rise of Bitcoin from under $100 to over [$6,000](#) in just a few years, the IRS is gearing up. Another IRS enforcement effort involves software. The IRS contracted with a company called Chainalysis to identify owners of digital wallets. From there, matching up transactions and tax returns is not that hard.

Taxpayers who have hidden income from Bitcoin and other digital currency sales could face taxes, and potentially big civil penalties. A few cases could even end up as criminal tax cases. So, at a minimum, you want to start keeping track and reporting going forward.

You might want to amend returns for the past too. Any attempted fix after the IRS contacts you is rarely as good as one you do yourself. Of course, some digital currency users have already been reporting their digital currency transactions on their tax returns.

But how do you know if you are doing it correctly?

Doing it right

The record keeping and gain and loss determinations can be dizzying. If this bill passes, many transactions would be in the clear. That would be welcome news for the digital currency community. Until then, here are a few more tips.

- What is the fair market value of digital currency? If it is listed on an exchange and the exchange rate is established by market supply and demand, convert it into U.S. dollars at the exchange rate.
- If you receive virtual currency as payment, must you include its fair market value in income? Yes, report the fair market value in U.S. dollars on the date you receive it.
- What is the basis of virtual currency received as payment for goods or services? The fair market value in U.S. dollars on receipt.
- If you “mine” virtual currency, do you have income from mining? Yes, when you mine it, the fair market value is income.
- Is mining virtual currency a trade or business that subjects you to self-employment tax? You bet. The IRS gets a piece of just about everything.

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