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Ten Tax Tips for Cryptocurrency: Expert Blog

EXPERT TAKE

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No one wants to think about tax bills from the IRS, much less interest and penalties. But if you are one of the legions of people capitalizing on the wild west of cryptocurrency, you might need to. At the very least, you should occasionally stop to think about the IRS and taxes. Here are 10 tips:

1. Remember, it's property.

You might not agree with the IRS, but the tax man says cryptocurrency is property. The IRS made this clear in Notice 2014-21. Cryptocurrency isn't foreign currency, and it isn't domestic currency, regardless of how you use it. That means every time you transfer it, you might trigger gain or loss. That means taxes.

2. Barter is old-fashioned, but the IRS gets a piece.

These are old rules, and cryptocurrency hasn't changed them. Property trades are taxed to both sides, even if one party just wants credit for later. Swapping one product or service for another is taxable, as the IRS explains at its Bartering Tax Center. Earning trade or barter dollars through a barter exchange is also taxable income, just as if your product or service was sold for cash. Plumbing for dental work? The IRS taxes it. You name the swap, it's income to both sides. Both must report the fair market value of goods or services received on their tax returns.

3. Careful with 1031 exchanges.

Most swaps of property are taxable to both sides, just like sales for money. There are exceptions for something called 1031 exchanges, but they may not apply to swaps of cryptocurrency. Besides, there are detailed rules to consider to comply with 1031. So, get some advice before you assume that any swaps might be tax free.

4. Not everything is long-term capital gain.

IRS Notice 2014-21 says Bitcoin and other digital currency is property, but that doesn't mean everyone holds cryptocurrency as a capital asset. If you are paid for services with it, that is ordinary income, and might even be wages. If you are a miner, you are earning ordinary income, perhaps even self-employment income. If you hold cryptocurrency and later sell it, whether you have capital gain or loss depends on whether it is a capital asset in your hands. For long-term treatment, you want to hold for more than a year. Keep good records too.

5. It might be less anonymous than you think.

The IRS is hunting digital currency users, using John Doe summonses to obtain data. The IRS is also hunting Bitcoin user identities with software. The IRS has a Chainalysis software contract to identify owners of digital wallets. Taxpayers with unreported income could face taxes, penalties, or even worse. Remember, the IRS also used a John Doe Summons to get names of Swiss bank account holders from UBS, and ended up collecting over $10 billion. The IRS may have cut its request for customer records from Coinbase to accounts with transactions over $20,000, but the IRS is clearly doing more data mining for digital currency users.

6. Careful when you pay for services.

Consider if you are paying an employee or independent contractor. Wages paid to employees using virtual currency are taxable, and must be reported on a Form W-2. Plus, they are subject to withholding and payroll taxes. If you pay someone in property, how do you withhold taxes? You could pay some cash and some Bitcoin, and withhold plenty on the cash. Payments to independent contractors are taxable, and payers must issue Form 1099. When you pay an independent contractor and issue Form 1099, you can't enter "1,000 Bitcoin" on the Form 1099. You must value it in dollars as of the time of payment.

7. Even small deals can trigger taxes.

If you use Bitcoin to buy a meal, that's a taxable transaction to both sides. Currently, there's no deal too small to attract the IRS. But that could change. A bipartisan bill, "The CryptoCurrency Tax Fairness Act," was introduced in the House by Rep. Jared Polis (D-Co) and Rep. David Schweikert (R-Az). It calls for tax exemption for all transactions under $600. But it hasn't passed. Stay tuned.

8. Don't report like it's 2015.

The IRS claims that only 802 people declared a capital gain or loss related to Bitcoin in 2015! This suggests that the vast bulk of Bitcoin transaction were not reported, at least in 2015. But in 2017, there is more awareness, and more fear. The current value of the cryptocurrency economy exceeds $200 billion. With millions of transactions and the meteoric rise of Bitcoin from under $100 to over $7,000 in just a few years, the IRS is gearing up.

9. Remember FinCEN too.

FinCEN, the Financial Crimes Enforcement Network, is part of the Treasury Department. The FinCEN rules say Bitcoin exchanges and Bitcoin miners should register as Money Services Businesses, and comply with anti-money laundering regulations. Given the pressures now facing financial institutions to hand over account holders, and to withhold and remit taxes, we should expect more from FinCEN and the IRS. Remember, U.S. taxpayers must report worldwide income on their tax returns.

10. Loans Might be Tricky.

Borrowers and lenders think of loans as non-taxable. There can be tax issues when loans are forgiven. Also, there may be interest income to lenders, and interest deductions to borrowers. Mostly, though, loans seem neutral from a tax viewpoint. You might think that loans in Bitcoin or other digital currency should be the same, but that's not clear.

When you receive a loan in cash, everyone understands that you will pay the lender back with other money. But the same is not necessarily true with a loan of property. In general, if you want to avoid taxes, a loan of property should require the return of the same property. With loans of cryptocurrency, the parties probably intend the cryptocurrency lent to be treated as fungible currency.

But a borrower may receive Bitcoins and sell them, repaying the lender with other Bitcoins, or with other forms of cryptocurrency. It's not clear if cryptocurrency loans will be taxed, but you should try to protect yourself in your loan documents if you are either borrowing or lending. Some suggestions appear here: IRS Could Tax Loans Of Bitcoin, Other Cryptocurrencies.

Taxes are complex. Be careful out there.