Haynie & Company
Certified Public Accountants
& Management Consultants

New Tax Rules for Virtual Currency (Cryptocurrency)

Urgent:
The IRS is taking special interest in virtual currencies. Starting with the 2019 tax year, on every Form 1040 we must answer the question: “At any time during the tax year, have you ever received, sold, sent, exchanged, or otherwise acquired any financial interest in any virtual currency?”

How are Virtual Currencies taxed?
Don’t be deceived by the name: virtual currencies are taxed more like stocks than currency. It’s not enough to just report one lump sum under the “virtual currency” category; each virtual currency you held during the year needs to be accounted for on your taxes separately. Your tax liability will be based on your gains/losses and how long you held each coin. Just like stocks, if you hold the currency for longer than a year then you reduce your tax bill by reporting long-term rather than short-term capital gains.

Liquid and Fractional
By nature, cryptocurrencies are extremely liquid. They are quick, easy, and cheap to transfer. Anyone with a debit card can buy Bitcoin in under 10 minutes starting from scratch. Creating a cryptocurrency account at Coinbase.com or Kraken.com lets you buy and sell thousands of different virtual currencies with a click of a button. Users will often open new accounts just to try out a new app on their phone. While that all sounds wonderful, every time a user transfers crypto between his/her own accounts, on different exchanges, it looks like a taxable transaction – but it’s not!

Sometimes, exchanges will automatically break down larger trades into a hundred smaller trades. When large trades are broken into smaller trades, the resulting transactions make it almost impossible to correlate in hindsight, especially because many coins are calculated out to 8, or even 12, decimal places. The overall effect is a fast, cost effective, decentralized financial network that is extremely difficult to calculate taxes on.

What Do I Have to Do if I Own Crypto?
Each time you sell or trade a coin, it needs to be reported on your taxes. And, whenever you buy something using crypto (even just a cup of coffee!), that also needs to be reported each and every time. That can be daunting. That’s where Haynie & Company comes in. We make your crypto taxes simple, fast, and painless.

The time to track virtual currencies can run in the thousands of dollars. Haynie & Company has crypto tax tools to get your virtual currency right the first time. Your tax professional will email you a link to connect your crypto accounts to our platform or to upload a CSV file with your transactions. That’s it. We’ll do the rest. As always, we are available to help if you have any questions along the way.

Determining FMV
One of the most complicated points in taxing virtual currencies is determining Fair Market Value (FMV). The basic question for any type of bartered exchange of value is “What is the value of the assets in US Dollars at the time of the transaction?” Answering that question can be difficult because crypto transactions don’t always have a clear US Dollar value. For example, if I trade 3 Bitcoin for 150 Ethereum in a private transaction, there isn’t an established value in dollars. It would be like swapping a Toyota for a Chevy: each vehicle has its own approximate value in dollars estimated by Kelly Blue Book, but they don’t quite match, and nothing is exact. As with all ambiguity in taxable value, the best practice is to be consistent in your valuation method. Haynie & Company has an enormous database of spot pricing that uses a weighted-average method to value virtual assets on a given date and time.

Virtual Currency

Governments have used digital currencies for decades. Any sort of government-backed currency is called "fiat" currency. In actual fact, whenever the Federal Reserve authorizes dispensing additional "cash" to central banks it just adjusts an electronic balance. The process is entirely divorced from physical cash. The central banks then lend it to other banks and so on down the line until they lend it to the end customer for things like car loans. Through that whole process, the money never actually becomes physical cash. Even when the consumer finally purchases a vehicle using a car loan, a cashier's check or ACH is sent to the auto dealer and dollar bills never change hands.

While government-backed digital currencies aren't new, "virtual" currencies typically refer to money that isn't backed by the government (aka non-fiat currency). Virtual currency has a much broader definition than just cryptocurrencies like Bitcoin. If you've been following Facebook's attempt to get regulatory support for its Libra coin, then you've probably heard arguments that it isn't a true cryptocurrency because of its centralized nature. Crypto purists argue that Libra is a virtual currency, but not a cryptocurrency. The argument highlights the trouble with regulating virtual currencies: they come in all shapes and sizes and no two are the same. The term "virtual currency" could be construed to include things like loyalty points at your favorite restaurant, credits for stock photos, or gaming tokens on mobile phone apps. It's hard to put a clear limit on the definition of virtual currency, but cryptocurrencies like Bitcoin and Ethereum certainly fall under the IRS's definition of virtual currencies.

Getting Paid/Paying Employees in Crypto

If you've been using crypto coins as payment for work, the same rules apply for crypto as for fiat payments. The only difference is that you're responsible to determine the FMV of the payments before calculating withholdings and taxes. If you would have been subject to payroll withholdings or self-employment tax on US Dollars, then you're still responsible for the withholdings and self-employment tax on crypto payments. Talk to your tax advisor about establishing consistent methods for determining the fair market value of your payments.

Buying Things with Crypto

Imagine trying to buy a cup of coffee using Apple stock instead of dollars and cents. That's essentially the transaction that takes place when you use Bitcoin to make a purchase. Whether it's a coffee or a Tesla, each purchase is a taxable event and you need to calculate and record the fair market value of the crypto you used at the time you made the purchase. Every store calculates the FMV differently and each payment card records transactions differently. Correlating the transactions with your tax records is an onerous task that is made infinitely easier with the help of your Haynie tax advisor.

What is mining and how is it taxed?

To understand mining, it's helpful to first understand how blockchain technology works. Simply put, the blockchain is just that: a chain of blocks. A block is a bundle of information. For cryptocurrencies, the information being stored is a record of the financial transactions going on between crypto owners. Once a block is full of data, it's given a name, let's call it Bob the Block. That name isn't random though; it's determined by the contents of the block. If any of the information inside the block was even slightly different, then the block would have been given a different name. The name of that block becomes the first piece of information in the next block. That's what forms the chain – each block is linked to the block before it by the name of the previous block.

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The names of the blocks aren't actually as easy as Bob the Block. In reality, the name of each block is a long list of random numbers and letters, uppercase and lowercase. That name is called a hash. It's generated by running the contents of the block through an encryption algorithm; it's like running the data through a filter that spits out the name of the block. So long as the contents of the block stay the same, the filter will produce the same name every time, but if even the smallest thing changes in the block, then the name of the block will be entirely different.

Mining is akin to being given a reward for guessing the name of the next block in advance. Right now, the Bitcoin reward is 12.5 coins' worth about $100,000, hence the appeal of mining! So miners set up their computers to guess at the name of the next block over and over and over again. It's a random race. The fastest computers get the most guesses and over time generate the greatest rewards. These days, governments and large corporations are actively involved in mining which pushes individual miners toward mining the less popular coins (altcoins) where they stand a better chance of earning a bounty.

Miners also make money by helping to maintain the integrity of the blockchain. Computers on the blockchain network constantly check to ensure that their piece of the blockchain still fits in with the rest of the pieces. That way, the whole blockchain isn't kept in just one place. The decentralized nature of the blockchain is what makes it practically impossible to hack. Decentralized financial applications are called "de-fi" or "dApps." As these networked computers double-check the transactions on the blockchain, they are awarded small amounts of crypto as compensation for their work. For Bitcoin, that reward is called a Sitoshi. For Ethereum, the reward is called Eth.

If you've been involved in mining or allowed your computer to be used for blockchain maintenance, then the reward you received is taxed like ordinary income. It might make sense to set up your crypto activity as a business rather than just a hobby. Talk to your tax advisor to get a better idea of how to save money on your crypto taxes.

Extra Credit: Forks, Airdrops, and Constructive Receipt

The IRS recently released additional guidance for cryptocurrencies to clarify "Constructive Receipt" in the case of "forks" and "airdrops." Clear as mud, right? Let's break it down.

Forks come in two flavors: soft and hard. A soft fork occurs when the blockchain community agrees on a change to the policies for that currency. They make the change, and everything goes on like normal. Computers on the network that haven't updated to the new protocol can still participate in mining and maintenance of the blockchain. A hard fork usually occurs when the community doesn't all agree to a significant change. When a consensus can't be reached, the blockchain branches into a primary and a secondary chain. If you owned a coin on the primary chain, then you typically receive a coin on the secondary chain too. In some ways it's like a stock split, except that the added stock would be in a new company. The IRS calls getting the free coins in the secondary chain a type of airdrop, although that's an usual use of the term.

The term air drop usually refers to free coins given out as part of a marketing effort. Airdrops are wonderful! You're essentially being given crypto for free. You may receive a new coin as a reward for installing software and trying it out. Or, everyone who holds a certain amount of Ethereum might just be given a few coins of new cryptocurrency for free in hopes of gaining traction for that coin and increasing its value. Other times everyone who subscribes to a certain podcast on a specific day might be given free crypto. The free coins are taxed like income just like mining or maintenance rewards. However, there are questions about how to determine the cost basis of the airdropped assets.

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Constructive Receipt is the principle the IRS uses to guide the calculation of cost basis for airdrops. It comes down to showing two things: when did you receive the asset, and when did you control the asset? Airdrops can take weeks or even months to take full effect. You may be notified that you received an airdrop weeks before you can actually control the currency. It's like someone telling you that they buried a gold bar in your back yard but it's so deep that it takes you several weeks to retrieve it in which time the value of gold has probably changed. Likewise, you can also technically have access to control of the asset but not know that you received it. That's similar to someone burying a gold bar in your backyard without telling you and by the time you find out, the value of gold has changed. Constructive Receipt establishes value at the point in time that you have both receipt and control of the asset.

We are Here to Help!

Virtual currencies grow and change so fast that it can be a full-time job just keeping up! Let us help you focus on what you do best. We are committed to staying on the cutting edge of technology and helping you manage your tax liability to meet your long-term goals. Please contact your tax advisor for assistance.

Contact Us

Many events can affect your tax situation. With proper planning, you can avoid negative tax effects. Please contact us in advance if you experience the following:

- Pension or IRA distributions
- Sale or purchase of a residence or other real estate
- Significant change in income or deductions
- Retirement
- Job change
- Notice from IRS or other revenue department
- Marriage
- Divorce or separation
- Attainment of age 59 ½ or 70 ½
- Self-employment
- Sale or purchase of a business
- Charitable contributions of property in excess of $5,000