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Cryptocurrency

and Blockchain Solutions

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Alternate Tax Solutions

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Background

The IRS has a new focus on cryptocurrency, and it is resulting in extensive attention to transactions, which could result in significant back taxes, penalties, and interest charges for not reporting taxable transactions using bitcoin and similar currencies.

The IRS has audited and obtained information from Coinbase as a result of a lawsuit. They were able to obtain much information on transactions flowing through the company's system involving fifteen million clients in their wallets. According to the IRS, only 847 taxpayers reported cryptocurrency transactions on their tax returns in 2015. Just recently, the IRS cryptocurrency task force has announced their recent mailings to taxpayers for unreported income and tax assessment deficiencies, and they will continue to process deficiency notices when their agents identify and quantify transactions of specific taxpayers involved in these transactions.

The court ordered Coinbase to turn over the records and information on more than 15,000 taxpayers involving transactions which exceeded $20,000 in the aggregate. The Treasury Department believes it now has the legal precedence to obtain the information from other "wallet" companies. Starting in 2018, new Treasury regulations have been promulgated requiring companies to provide and file form 8946 to report crypto-currency transactions like the brokers' 1099-B forms received for stock transaction.

Within the next six months, the IRS will be aggressively contacting millions of taxpayers who neglected to report these transactions. The accounting profession will need to identify and verify this activity and the basis of each transactions. Like unreported stock transactions, the deficiency notices focus upon the gross amount of the transactions and ignores the cost basis of the transaction. If the client does not respond within the statutory periods to the notices and does not file timely appeals, the taxpayer will be obligated to pay the taxes, penalties, and interest on the gross transaction instead of the net gain.

As a result, the accounting profession will need to assist the clients on how to verify the transaction and document the basis of each transaction. This is extremely detailed and difficult due to the volatile exchange nature of the bitcoin and other markets during the past three years.

The IRS anticipates that billions of unreported incomes will generate significant taxes, penalties, and interest for the treasury. These audits will generate much activity and fee opportunity among tax accountants and lawyers. The profession will need to know how to account and audit the transactions so the client does not overpay their tax obligations.

To minimize future like-kind exchange issues, the IRC wants changes in 2018 to restrict like-kind exchanges to real estate transactions only. The Treasury Department needed to restrict arguments whereby taxpayers could claim like-kind exchanges between various "types" of currencies and/or

investments. The IRS does not allow coin-to-coin trade to be treated like Section 1031 “like-kind exchange,” where they may defer income to the replacement position’s cost basis.

(**Coin-to-coin trades do not qualify for deferral of income.)**

Other issues can arise when a taxpayer utilizes business accounts or funds to purchase the cryptocurrency and then loses the transaction or uses the cryptocurrency to purchase personal items or other investments on behalf of officers or shareholders. It is important to note that Virtual Currency is considered intangible property (not money). This a critical point because each use of money is not a taxable event; however, the use of Virtual Currency is a taxable event.

What are Taxable Events?

Coin-to-currency sales are capital gains and losses.

When taxpayers purchased Bitcoin for $12,000 in 2014, then sold all of it in for $32,000 in 2017, they should have reported a capital gain of $20,000 on their 2017 tax return form 8949. If the taxpayer held the coin position for one year or less, it is considered a short-term capital gain taxed at ordinary tax rates (up to 39.6% for 2017). If the position was held for more than one year, the long-term capital gain rate (up to 20% for 2017) applies.

Purchasing goods and services with coin:

When a taxpayer pays for a service or purchases a good with cryptocurrency, the taxpayer has triggered a short-term capital gain that needs to be reported on tax form 8949.

Example

A taxpayer purchased five Bitcoins at $2,500 each on January 1, 2017, for a total cost basis of $12,500. On June 1, 2017, when the price of a Bitcoin unit was $5,000, the taxpayer used one Bitcoin to purchase a new desk for an invoice price of $5,000. The market value of the virtual currency used to purchase the desk is $5,000. the taxpayer cost basis for the virtual currency is $2,500. The net short-term capital gain is $2,500. If the taxpayer uses the desk in his business, he will deduct $5,000.

Coin splits in hard forks are taxable income.

A hard fork is when a cryptocurrency splits in two. It occurs when a cryptocurrency code is changed resulting in both old and new versions. The hard fork is meant to create two coins.

Example:

Bitcoin had a hard fork in its blockchain on August 1, 2017, dividing into two separate coins, Bitcoin vs. Bitcoin Cash. Each holder of a Bitcoin unit was entitled to arrange receipt of a unit of Bitcoin Cash. The Bitcoin price on August 1, 2017, was $2,801. The Bitcoin cash unit was 9.5% of Bitcoin or $266. Bitcoin taxpayers were distributed one unit of Bitcoin Cash (for $266) per unit of Bitcoin owned. The Bitcoin taxpayer should report the valued received as “other income” on line 21 of form 1040.

What should the accounting and tax practitioners need to know and advise?

(Advise your clients not to mix business crypto addresses with personal addresses.) An accounting/tax professional needs to know how to address the cryptocurrency accounting, recordkeeping, and transactional issues affecting cryptocurrencies, then how to read and identify each specific transaction. They need to establishment proper accounting policies, procedures, methods, and conventions that should be implemented for this space.

For example, when a taxpayer is very active in the cryptocurrency space, they may have hundreds of transactions spanning several wallets and various types of cryptocurrencies which involve numerous transfers among the various wallets. This situation may pose multiple issues, such as the following questions:

1. Which types of transactions are taxable?
2. When is a gain on each transaction recognizable?
3. When does one need to withhold federal income taxes on such transactions?
4. Are there any state tax issues or nexus issues needing to be addressed?

(**Reported fiat values in the transaction history for tokens sent, almost never line up one-to-one with agreed upon fiat values.**)

Other possible questions that arise are: When multiple transactions occur, which method or convention does one follow? Should the accountant use specific identification, average cost, first-in/first-out or last-in/first-out methods in identifying the basis of currency sold or transacted? When one purchases a cryptocurrency and cashes in a crypto- currency, when does one recognize a gain?

When one purchases one type of cryptocurrency and purchase a different type of cryptocurrency, is there a gain to be recognized when the value of the initial currency increased significantly prior to the purchase of the other crypto currency? By opening up Pandora's box, all types of questions will need to be addressed by the practitioner in this crypto-blockchain arena.

The practitioner will need to address with each taxpayer the proper accounting methods and convention elections, as well as the bookkeeping, accounting, and documentation needed for proper reporting of transactions in the future. The taxpayer will need to know that their Uncle (Sam) wants to share in their new prosperity. There are many new revenue-recognition rules being considered by the Treasury Department, which will tighten up this new area of reporting and taxation. The recent court ruling, which occurred in 2016, enables the IRS to extend the statute of limitations to 2013, instead of 2015, while the IRS initiates their initial investigations of the crypto wallets. As we all know, if intentional concealment of taxable income occurred, there is no statute of limitation.

The following are only minimum items a practitioner needs to do when their clients are active in the crypto arena and to maintain professional standards to avoid preparer penalties:

1. Advise the taxpayer of the ongoing investigations by the IRS.

2. Advise the taxpayer to maintain accurate accounting records of all transactions.

3. Assist the taxpayer to develop proper accounting policies and procedures.

4. Advise your client to keep an addendum ledger that specifically tracks your cryptocurrencies. Make sure they record the transaction hash in the letter.

5. Keep separate ledgers for each cryptocurrency. The ledger should include the following information: date; recipient or sender's name; total amount of coin treated as income, expense or trade; the value at the time of the transaction; the transaction hash; and a memo that states the kind of income, expense, or trade that occurred (i.e. service income, perhaps, a project name, etc.)

6. Assist client to develop proper risk management and security measures involving the wallet keys.

7. Keep supplemental evidence of transactions in receipt form, exactly like credit cards or bank statements. The best way this can be accomplished is to take screen shots of the transaction.

8. Also include any additional invoices from vendors, customer contracts, and/or supporting emails. This is important for accounting continuity if you have any personnel changes or if any outside party needs access to the records.
9. Review and test the client's accounting records for proper documentation.

Conclusion:

There are many problems ahead for taxpayers who have not paid taxes on cryptocurrency. The IRS will have the ability to go back to the tax year 2014 in order to access back taxes, penalties, and interest. This is an easy audit for the IRS, because all transactions are public and immutable. Establishing the correct basis for the IRS could be difficult in some situations given the interoperability between multiple wallets, domestic and foreign exchanges, and users. Third-party expertise will probably be needed.

Many people have been utilizing cryptocurrency for the purchases of goods and services and have not realize that there is a capital gain or loss that needs to be reported. Alternate Tax Solutions recommends that a taxpayer should amend prior tax returns and report capital gains before the IRS catches up with them.

The increase in the number of Initial Coin Offering (ICO) displays a trend where investors are finding alternative venture capital from offering tokens instead of stock options. An example of this is a messaging company, Telegram, raised 1.7 billion dollars. Stocks are regulated by the Security and Exchange Commission, and crypto currency has no regulating body, thus opening the door for ICO scams. Most governments are apprehensive about how to precisely classify ICOs and, therefore, how to govern and tax them.

The growth and utilization of cryptocurrency is expected to grow worldwide. An IDS study predicts by the year 2022, there will be 11.7 billion dollars in cryptocurrency purchases and transactions globally. Currently, Bitcoin is the dominate cryptocurrency, but recent studies by Abeer Elbahrawy at City University in London suggest that Bitcoins market share will drop dramatically over the next couple of years. Experts predict that in the future, countries will move from currency based on fiat to digital currency because money has been moving from the physical to the digital realm. A method of securing digital currency is becoming more and more important. Blockchain, which is the underlying technology for Bitcoin, is gaining acceptance and popularity mainly because there have not been any security breaches since its inception in 2009.

The Bank of England is working its own cryptocurrency (see Global Public Investors, July 2017 edition). In fact, they have created an experimental cryptocurrency, called RSCoin, that would utilize a centralized system. Estonia is working creating a blockchain residency program, and part of the program includes launching an estcoin. In the United States, there has been talk about putting the Federal Reserve on Blockchain, thus, eliminating or limiting the need for banks. Christian Catalini, Assistant Professor at MIT Sloan School of Management, argues that it would allow the Federal Reserve to do a better job of stabilizing and regulating the economy. Many experts are also saying that blockchain and cryptocurrency are the beginning of the next industrial revolution.