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Cryptocurrency [Bitcoin] and the IRS

01/23/2018

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The creation and use of cryptocurrency is very recent. Back in 2010, it just began trading. In 2011, it hit its first “bubble” at $31 per coin when previously they traded for just pennies. Most people by now have already heard it hit nearly $18,000 in December 2017. That’s quite a leap in just 7 years.

If you wish to learn all about cryptocurrency and the blockchain technology behind it, which may become an important tool for many businesses in the future, go to the *Wikipedia*’s History of Bitcoin. This article is not about what bitcoins are, but is about what you need to know about their income tax and reporting aspects. And this article is a very over-simplified view to point out the issues and give you some guidance as a start.

For many years, no one even knew what bitcoins were other than a new concept and there was an exchange where you could buy and sell such “currency.” I put that in quotes because, in fact, it’s not considered a currency by the IRS even though people see it as currency. The IRS treats bitcoin assets as “property.” In 2014, the IRS issued a Notice 2014-21 in which is described the IRS’s position on the buying and selling of such assets, and using them to pay for goods and services. Because it’s not treated as a currency, despite being named cryptocurrency, the impact can be quite different depending upon how you acquire these bitcoins and what you do with them after you acquire them.

If all you do is buy and sell bitcoins, then these coins are treated the same as if they were stocks or bonds. When you buy them, you are holding them at the “tax basis” you paid. If you use bitcoins to buy and sell goods or services, then it’s a taxable event each time you do. If you “mine” bitcoins, then it’s a business and you pay income taxes AND self-employment taxes on the fair market value of coins received (the concept of “mining” bitcoins is yet another article not addressed here).

The IRS’s position is that cryptocurrency is misnamed and is NOT currency at all but is property. As such, whenever such currency is traded or moved in any way, there’s a taxable event. This can be true if you trade it between exchanges, you move it from one wallet to another and so on. The IRS issued “frequently asked questions” in IRS Notice 2014-21. In terms of cryptocurrency history, that was the technology equivalent of a million years ago. Much has changed since then. For example, in late December 2017, the new tax law changed Tax Free Exchanges (Internal Revenue Code Section 1031) dramatically by elimination of all exchanges except real estate for real estate. Thus, an exchange of one cryptocurrency for another cannot be treated as a tax free exchange and therefore is taxable. Prior to 2018, most tax practitioners felt that Section 1031 allowed for exchange to exchange with no tax cost because the “coins” were property.

Another area of IRS reporting concerning bitcoins is what’s called FBAR or Foreign Bank Account Reporting [which is reported on Form 114 and also on Schedule B of your 1040). The IRS’s position has long been that when a US taxpayer (i.e. a citizen, green card holder or resident] parks money in a website that is overseas, they have a foreign financial account that requires reporting as an FBAR. Because the failure to report an FBAR has such a high cost (willful failure to report means a penalty of the higher of $100,000 or 50% of the highest amount the account had during the year) it’s not an area you want to be wrong about. Although both the IRS and FinCEN (Financial Crimes Enforcement Network) are under the Treasury Department, the IRS says bitcoins are property and FinCEN says they are currency.

Then there’s the more difficult accounting aspect to all this. Each time currency moves in any way, you must account for it. Some exchanges, such as the more well-known Coinbase Inc., are now required to report such transactions to the IRS under a recent (November 2017) court case which Coinbase lost when the IRS sued them. But many exchanges will not report this to anyone and unless you have good records, the burden is on you to show what you made or lost. How do you account for it? Most people will want to have an accounting method. Two common types are “First In First Out” (FIFO) or “Last In First Out” (LIFO). Most of you would want LIFO since that way you are selling currency today with the highest tax basis and therefore the lowest capital gain. However, remember that if you trade frequently, the last one in may not qualify you for long term capital gains which requires a holding period of at least one year. LIFO might well be less than a one year hold so you won’t qualify for long term capital gain’s lower tax rate. Also, you can use a moving average as you would a mutual fund, but remember that you cannot mix and match. Each currency and exchange must be kept separately.

Also, consider carefully the fees to utilize these transactions. The cryptocurrency websites charge all types of fees and they vary considerably depending upon many factors. These include fees to add money to your account such as using a credit card or ACH from your back account. There are exchange rate fees, conversion fees and these can be minimum fees and percentage fees. They also depend up the size and volume. Coinbase Inc. (Bitcoin) charges fees based upon what country you are in at the time. And then you must consider whether you can deduct these fees. These fees are considered investment fees since the cryptocurrency is treated as property. So because the new tax law eliminated such fees as deductions on Form 1040, Schedule A, those fees cannot be deducted anywhere unless it's a trade or business on Schedule C, or a corporation.

And given the volatility of the values of these assets, what about losses? If you are just investing in these assets and you dispose of some by selling, transferring or using them to buy something at a value less than you paid, you have no more than a capital loss and those can only be used to offset capital gains or no more than $3,000 per year. And keep in mind that here in Massachusetts, if you sell these assets at gain and it's short term, the tax rate of 12% and given the new law disallowing state income tax deductions over $10,000, such rate can really undo the gains made.

Because cryptocurrency is not a security, the "wash sales rules" don't apply. Thus, you can sell currency at a loss, and buy it right back at the lower price and use that loss to offset current year gains. That differs with a security where you have to wait 30 days to buy it again to permit using the loss.

Another potentially large issue for taxpayers is the new law's pass-through entity deduction in IRC Section 199A. Since the law was just signed in late December 2018, this only raises more questions than it answers but is something to be aware of in tax planning.

As you can see, the tax aspects of touching any cryptocurrencies is complex to say the least. I highly recommend you plan this all out BEFORE you see profits. Understanding your record keeping requirements at the outset will help you enormously and then when it's time to report the transactions on your returns, you and your preparer will not be surprised.

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