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Income, from Whatever Exchange, Mine, or Fork Derived: The Basics of U.S. Cryptocurrency Taxation

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In this first of (we hope) many posts on the interesting and myriad tax issues arising in the world of cryptocurrency and blockchain technology, we focus on the very basic U.S. federal income tax consequences of cryptocurrency transactions. The following is a very high-level discussion of the consequences generally applicable to U.S. individual holders of cryptocurrencies, and will not be applicable to all taxpayers depending on their particular situation.

Is it property or is it money?

While it might seem an academic question, the distinction between property and currency is the key to the U.S. federal income taxation of cryptocurrencies. Gain on nonfunctional foreign currency exchanges (i.e., currencies other than the main currency used by a trade or business) is generally ordinary income, and therefore taxable under current law at marginal rates up to 39.6% (or 43.4%, factoring in the net investment income tax). In contrast, gain or loss on the sale of property can constitute either ordinary or capital income, depending on whether the property sold is or is not a capital asset. If a capital asset, the reduced long-term capital gains rate (up to 23.8% under current law, including the net investment income tax) could apply if the asset sold was held for more than one year.

There are good arguments for treating cryptocurrency as money and as property, the theoretical merits of which are beyond the scope of this post. For present purposes, the opinion that matters is that of the IRS, and fortunately the IRS has given us some guidance. In Notice 2014-21, the IRS declared that "convertible virtual currency," i.e., virtual currency having an equivalent value in "real currency" (such as the U.S. dollar) is "property" for U.S. federal tax purposes. Therefore, the tax treatment of cryptocurrency transactions will generally follow the rules applicable to transactions involving non-cash property.

Whether income recognized on an exchange of property is ordinary or capital will generally depend on whether the property exchanged is a "capital asset" in the hands of the seller, which depends on the taxpayer's purpose in holding the property. Property held for investment purposes (i.e., in anticipation of the property's appreciation over time) generally will be treated as a capital asset. The same type of property, if held as "inventory" of the taxpayer (i.e., for sale to customers in the ordinary course of the taxpayer's trade or business), would not qualify as a capital asset. In other words, coins purchased and held by an investor would generally be a capital asset, whereas coins held for sale by a dealer in cryptocurrencies would not.

How is income (or loss) calculated in a coin exchange?

In a transaction for cash

When cryptocurrency is purchased for U.S. dollars, the purchaser generally will take a tax basis in the coins equal to the amount of cash paid. Later, when the coins are sold to another party for U.S. dollars, the amount of taxable gain (or loss) on the sale is the difference between the purchase price and the later sale price. As explained above, whether the taxpayer's gain or loss is capital or ordinary depends on whether the coin was a capital asset in the hands of the taxpayer (i.e., whether the property was held for investment). If a capital asset, the applicable tax rate will depend on whether the coin was held for longer than a year.

In a transaction for property and/or services

Cryptocurrencies are considered a type of property other than money. Therefore, when coins are used to purchase other (non-cash) property and/or services, the exchange is a property-for-property exchange (i.e., a "barter" exchange). Generally speaking, when a taxpayer exchanges property for other property in a taxable sale, the amount "realized" by the taxpayer is the fair market value of the property received (measured as of the sale date). The amount of gain or loss realized by the seller is the difference between the amount realized and the seller's basis in the cryptocurrency used to make the purchase. The buyer would acquire a tax basis in the cryptocurrency received equal to its fair market value on the date of exchange.

To illustrate by way of example, imagine that John, a U.S. individual taxpayer, purchased Bitcoin as an investment for its fair market value in cash in a single transaction dated November 8, 2015 (closing price reported on CoinDesk: $373.49). If exactly two years later, on November 8, 2017, John uses Bitcoin (closing price reported on CoinDesk: $7,458.79) to purchase a bag of mini-donuts for $5.00 from a donut shop in Austin, Texas, John would have taxable gain on the difference between the fair market value of the donuts ($5.00) and John's basis in the Bitcoin used in the exchange. Assuming that the CoinDesk closing price for Bitcoin represents fair market for the date of the transaction, John would have taxable gain on his purchase of the donuts equal to approximately $4.75 [$5.00 * ($7,458.79 – $373.49) / $7,458.79 = $4.749]. Because John acquired the Bitcoin for investment and held it for more than one year before using it to buy donuts, John's gain would be taxed at the long-term capital gains rate. The donut shop would have gross receipts of $5.00 from the sale to John and would take a $5.00 tax basis in the Bitcoin received.

In an exchange of coins for coins

Under Notice 2014-21, an exchange of coins of one cryptocurrency for another denomination of cryptocurrency will in most cases be treated as a taxable sale. The amount of gain or loss realized on the sale is the difference between the taxpayer's basis in the cryptocurrency exchanged (usually the U.S. dollar value of whatever "real" currency was used by the taxpayer to purchase the cryptocurrency) and the fair market value of the cryptocurrency received as of the date of the exchange.

Note: Some commentators have suggested that cryptocurrency-for-cryptocurrency exchanges might qualify as "like-kind exchanges" under section 1031 of the Code, which would defer tax on any unrealized appreciation in the exchanged. Although an interesting idea—and a potential topic for a future blog post—this question may soon be moot if the tax bill currently being debated in Congress passes in its current form (at least for exchanges taking place after December 31, 2017).

Other taxable cryptocurrency transactions

Cryptocurrency-denominated compensation

An employee that receives compensation denominated in cryptocurrency is subject to tax on the fair market value of the coins received. Additionally, cryptocurrency paid to an employee as compensation is generally treated as "wages" for employment tax purposes, and therefore subject to federal income tax withholding as well as unemployment and FICA taxes.

Currency "mining" activities

A taxpayer who acquires cryptocurrency as a result of "mining" activities (i.e., the consumption of computer resources to maintain a blockchain ledger) will generally realize gross income upon receipt of the coins mined equal to their fair market value on the date of receipt. An individual taxpayer engaged in cryptocurrency mining as a trade or business (and not as an employee) will also have to pay self-employment taxes on the fair market value of any cryptocurrency received.

Coin "splits" and "hard forks"

As explained above, exchanges of property for other valuable property generally results in taxable gain (or loss) equal to the difference between the fair market value of the property received and the taxpayer's basis in the property exchanged. Although this general principle also applies to exchanges of one cryptocurrency for another (e.g., Bitcoin for Ethereum), it is not clear if (or how) this principle applies where an entirely new cryptocurrency splits off from an existing cryptocurrency (e.g., Bitcoin Cash and Bitcoin), also known as a "hard fork." While most people would agree that Bitcoin Cash has value (the trading price of a single coin has topped $1,700 in recent days), it's unclear when this value is "income" for tax purposes, the amount of income realized, and the tax character of this income.

The most straightforward treatment, arguably, would be to treat the additional coins received in a cryptocurrency fork as a pure windfall (similar to lottery winnings) under the basic test for income set forth in *Commissioner v. Glenshaw Glass* (U.S. 1955): it's an undeniable accession to wealth, clearly realized, over which the recipient has complete dominion and control (assuming the recipient had access to the new cryptocurrency through its digital wallet). The result would be ordinary income to the recipient equal to the fair market value of the property received as of the date of receipt and without any reduction for the return of capital (i.e., the recipient's basis in the cryptocurrency immediately before the split).

While sound as a matter of general tax principles, this approach presents significant practical challenges. Sticking with Bitcoin Cash as an example, it's unclear when the initial recipients of Bitcoin Cash actually "realized" this income. Depending on where Bitcoin holders stored their Bitcoins, some recipients did not have (and could not get) the digital keys necessary to immediately access the Bitcoin Cash (and/or convert the Bitcoin Cash into actual cash), raising a question of "dominion and control" under the *Glenshaw Glass*test. Just as significant is the valuation difficulty. There was no readily available market for Bitcoin Cash until sometime after the split and, even then, trading prices varied considerably among the different exchange platforms. Although the initial value of the Bitcoin Cash distributed to Bitcoin holders was, nominally, equal to the value of the recipients' Bitcoin holdings, the values of the two cryptocurrency products quickly diverged as a separate market for Bitcoin Cash emerged. (The expectation often in hard forks is that only one of the two resulting cryptocurrencies will survive.) The uncertainty surrounding the moment of realization further complicates matters: given the market volatility of cryptocurrencies, shifting the testing date for fair market value even a day or two can have a significant effect on the amount of gain realized.

Another approach would be to look at coin forks as analogous to dividends paid with respect to stock. Stock dividends and stock splits that do not result in a change in the recipient's proportionate ownership of the issuing company are generally not taxable events. Any built-in gain is deferred until the stockholder sells or otherwise disposes of its stock for money or other property. In contrast, the receipt of a *cash* distribution is a taxable event and can result in ordinary income, return of basis, and/or capital gain to the recipient, depending on the particular circumstances. While analogies can be drawn to coin splits, the tax treatment of dividends is determined under statutory rules specific to distributions to stockholders; and although cryptocurrencies are property, they are not treated as "stock" for tax purposes. Extending these rules to cryptocurrency distributions would likely require action from Congress.

Alternatively, the IRS could treat a cryptocurrency split as not a taxable event at all, if the converted currency is substantially identical to the property previously held by the taxpayer. Rather than recognizing gain at the time of the split, the unrealized gain inherent in the additional coins issued would be taxed when the coins are converted into cash or used to purchase property or services. This approach might make sense for a traditional split—for example, if each holder received additional coins of the *same* cryptocurrency but the aggregate exchange value remained exactly the same immediately after as immediately before the split. But it's difficult to make a "substantially identical" argument in the case of a hard fork, given that it actually results in the creation of a new cryptocurrency having its own blockchain and an independent value. There is also potential for value redistribution in a hard fork that would not be present in a pure split. Although all holders of Bitcoin nominally received an equivalent amount of Bitcoin Cash in that fork, not all holders had the digital keys to access the new coins and not all storage platforms supported the new currency. If the two currencies are viewed as sharing in the same underlying market capitalization, this means that some of the value of original Bitcoin shifted to Bitcoin Cash in the fork, resulting in a disproportionate gain to those with access and a corresponding loss to those without.

As of this writing, there has been no IRS guidance published specifically addressing this issue, leaving considerable uncertainty for those recipients of the estimated $5 billion worth of Bitcoin Cash released earlier this year.

How is income from cryptocurrency transactions reported to the IRS?

Gain (or loss) on cryptocurrency exchanges

U.S. taxpayers must report their gain and loss from Bitcoin transactions just as they would gain and loss from any other property transaction. Because cryptocurrencies do not meet the definition of "covered securities" for U.S. federal tax purposes, a coin exchange is not required to issue Form 1099-B informing taxpayers of their gain or loss on brokered coin transactions. Taxpayers are therefore required to determine their tax basis in the coins they acquire and to keep track of this basis in order to calculate gain or loss upon later sale. Some coin exchanges may allow users to download a file of their account history so they can track gains and losses for tax purposes. This amount is then reported to the IRS on the individual's tax return.

Income received as payment for goods or services

Employees or independent contractors that receive cryptocurrency as payment for services should receive a W-2 or 1099-MISC, as applicable, indicating the fair market value of the cryptocurrency paid as of the date of payment. Notice 2014-21, as well as general U.S. tax principles, imposes specific information reporting requirements both on employers and on persons who purchase services from independent contractor for use in their trade or business. Third party settlement organizations (TPSOs) such as Coinbase are also subject to reporting requirements if the value of the transactions they settle exceeds a dollar threshold.

A note on valuation

Assuming the cryptocurrency is both acquired and sold for cash, and adequate records are kept, the amount of any taxable gain or loss should be fairly straightforward to calculate. In contrast, if a taxpayer acquires coins by mining, or receives coins as payment for goods or services (or in exchange for other coins), determining the coins' fair market value as of the relevant testing date can be a significant challenge. In addition to volatile day-to-day trading prices (over the course of less than three weeks, the trading price of Bitcoin dropped as low as $5,857.32 before rebounding to a price over $10,000 on some Korean exchanges), cryptocurrencies generally lack a centralized trading platform (or, initially, *any* formalized trading platform), making it difficult to identify a single market price.

Financial crimes and tax evasion

Notwithstanding the general characterization of cryptocurrencies as property for U.S. tax purposes, the U.S. Treasury's Financial Crimes Enforcement Network (FinCEN) regards cryptocurrency exchanges as "money service businesses," or MSBs. Although a cryptocurrency is not itself "money," cryptocurrency exchanges are required to report when Bitcoin is exchanged for large amounts of money under rules intended to prevent money laundering. Some cryptocurrency exchanges have complied and registered with FinCEN as MSBs, although others have resisted.

U.S. taxpayers that hold foreign bank accounts denominated in cryptocurrency may be required to report these accounts under the Report of Foreign Bank Account (FBAR) rules if the value exceeds $10,000 at any point in the calendar year. U.S. individual taxpayers are also required under the Foreign Account Tax Compliance Act (FATCA) to report to the IRS any foreign financial assets valued at $50,000 or more.

Conclusion

Although intended as a summary of the existing tax laws applicable to cryptocurrency transactions, this summary raises as many questions as it provides answers. As cryptocurrencies continue to gain in popularity and are used in a wider variety of transactions, the tax issues implicated are likely to grow ever more complex. For example, this post does not touch on the tax consequences of initial coin offerings (ICOs), which are starting to outpace venture capital as a primary source of start-up funding. Additional guidance from Congress or the IRS is sorely needed to resolve some of the uncertainty surrounding tax treatment of cryptocurrency transactions and to give taxpayers a clearer roadmap for compliance.

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