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Bitcoin, ICOs, and the IRS - the Tax Issues

How Does the IRS Tax Bitcoin and Other Cryptocurrencies?

Featured Story

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Bitcoin and other cryptocurrencies raise numerous tax issues, including how they are taxed, when cryptocurrencies are reportable on FBARs, and whether cryptocurrencies qualify for favorable tax deferral strategies such as like-kind exchanges.

For now, the IRS will treat cryptocurrencies as property and not as currency, resolving significant uncertainty and avoiding the complex rules that can apply to the taxation of currency transactions. Like other property, a taxable event therefore occurs upon selling or trading cryptocurrency whether privately or through an exchange. A taxable event will also occur if one uses Bitcoin or another cryptocurrency to buy goods or in another similar transaction. And those that are mining cryptocurrencies will owe taxes when they are awarded a coin or portion of a coin.

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Because the IRS classifies cryptocurrencies as property, they are treated like other capital assets. Realized and recognized gains are subject to the U.S. capital gains tax. If the holding period is one year or less, the gains are taxed at short-term capital gains rates, which are the same as ordinary income tax rates. If the holding period is more than a year, then the gains are taxed at the preferential long-term capital gains rates. Like other capital assets, the gain is the difference between the amount realized and the owner's basis (typically the acquisition price).

Gain for the sale or exchange of cryptocurrencies is reported on Form 8949, Sales and Other Dispositions of Capital Assets, on the owner's personal income tax return. This will usually be due on April 15 of the year following the sale or exchange, subject to extensions or other provisions that might change the due date of that return.

One important caveat here is that dealers or full-time cryptocurrency traders may be subject to different rules.

Cryptocurrenices and FBAR Reporting

Another issue is whether cryptocurrencies are subject to FBAR reporting. Here, the IRS has not offered any guidance. U.S. citizens and residents (including domestic corporations, partnerships, trusts and other entities) are required to file an FBAR each year to report signatory authority or interests in foreign bank or financial accounts. The FBAR is generally required when the cumulative value of those accounts exceeds USD10,000, and it is required regardless of whether there is any tax due from those accounts. The penalty for willful failure to report an account can be 50% of the value of the unreported account.

Items of property, including foreign currencies and precious metals, that are held directly by the taxpayer are not required to be reported on an FBAR. However, that result can change if the property is

held through some sort of a custodial account at a foreign financial institution.

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Similarly, taxpayers who hold cryptocurrencies directly in their own possession likely do not have to report these holdings on an FBAR. However, FBAR reporting is likely required if a U.S. person's cryptocurrency is held at a foreign exchange or in some other sort of online account, and reporting may also be required on Form 8938, Statement of Specified Foreign Financial Assets, filed with the taxpayer's yearly income tax return.

With the uncertainty in whether reporting is required and the potentially high penalties for willful failure to report, the best practice is to report foreign cryptocurrency accounts on FBARs and Forms 8938.

Cryptocurrencies not Eligible for Like-Kind Exchanges

While tax is generally owed on the disposition of a capital asset, there are some provisions in U.S. tax law that permit the gain to be deferred until a later time. One such provision is the like kind exchange rules. Under these rules, which are complex, a taxpayer can exchange a piece of property with a built-in gain for another "like kind" property without recognizing some or all of the gain. The gain is deferred until the disposition of the like kind property -- often a significant time into the future.

The like kind rules previously allowed the exchange of personal property (as opposed to real property), subject to complex and oftentimes narrow restrictions on what constituted like kind property. Under the prior rules, it was not entirely clear if cryptocurrencies qualified for like kind exchanges, or if so, what constituted like kind property. For example, was Bitcoin like kind to Ethereum, or Bitcoin like kind to Bitcoin Cash?

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While those prior like kind exchange issues were never fully resolved, the landscape has now changed, and not favorably. At the end of 2017, the U.S. passed a sweeping tax reform act, and one change was to limit like kind exchanges to real property. There is now certainty that cryptocurrencies do not qualify for the like kind exchange rules.

IRS Enforcement of Cryptocurrencies

The IRS has shown some interest in pursuing cryptocurrency holders who fail to report gains on the sale of their assets. In one highly publicized case, the IRS sought information from Coinbase, a U.S. exchange, about clients who engaged in cryptocurrency transactions.

One of the interesting points that came out during the Coinbase case was that from 2013-15, only about 800- 900 people per year filed a Form 8949 with their individual income tax returns to report sales or exchanges of property that is likely to be Bitcoin-

related. With the growing popularity of cryptocurrencies, one would expect the actual number of Bitcoin transactions through Coinbase to be far greater each year, which indicates that a significant number of people are not reporting their profits from Bitcoin.

The IRS will undoubtedly continue to pursue cryptocurrency transactions to make sure that taxpayers property report their gains. Whether the IRS undertakes a large scale enforcement effort in this area remains to be seen, but taxpayers are best advised to understand how the tax laws apply to cryptocurrencies and remain compliant in case the IRS does come calling.

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