by Damien B. M. English

Crypto Cares

The Rise of Virtual Currencies and You

Cryptocurrency is a prevalent topic in financial news these days, falling in and out of favor depending on whom you ask. Institutions are decrying it in one instance, then taking large amounts of it on to their books in another. Goldman Sachs, Morgan Stanley, JP Morgan and Bank of America—to name a few—have all dipped their toes in the volatile crypto waters.

Moreover, as the value of the various stablecoins and cryptocurrencies pings up, down and sideways, retail investors have been getting in on the act, not wanting to miss out on the next big thing—or rug pull for the less fortunate.

If anything, the retail market's interest in virtual currencies will mean CPAs can expect to deal with the tax logistics come tax season, and we asked some CalCPA members for their comments on the topic to help you get your mind around what you might expect. We received input from CalCPA Personal Financial Planning Committee Member **Dan Herron**, CPA/PFS CFP (partner, Better Business Financial Services; principal, Elemental Wealth Advisors) and Moss Adams Senior Manager **Erik Weinapple**, who recently gave a presentation on the topic to CalCPA's Committee on Taxation.

A Q&A with Erik Weinapple

WHAT DO YOU THINK CRYPTO REGULATION MIGHT LOOK LIKE?

It's hard to say. The current infrastructure bill is attempting to redefine the definition of a broker and possibly push cryptocurrency exchanges like Coinbase and others to begin reporting 1099 information to the IRS on behalf of their customers, similar to what traditional brokerages currently are required to do. I think that's the start. The hard part will be figuring out regulations that will help track information without being overly burdensome to the crypto space and effectively slow down innovation. Some traditional rules will be hard to follow especially in the decentralized finance (DEFI) space whereby there are no real service providers and "customers" interact directly with a protocol rather than with a human. Forcing 1099 tracking to KYC rules on these types of platforms may be impossible or if possible, overly burdensome to the industry.

WHAT ARE THE TAX IMPLICATIONS SURROUNDING CRYPTOCURRENCY?

That's a loaded questions since it all depends on what you're doing with crypto. If you buy and hold as a long-term investment, you're likely going to see similar treatment to if you bought and sold stock. If you are mining or staking crypto, then you'd likely end up with trade or business income treatment under Tax Notice 2014-21. I'd recommend reviewing Tax Notice 2014-21, along with the IRS FAQs as a start for guidance on how to treat cryptocurrency transactions. Currently there's no specific guidance on how NFTs (non-fungible tokens) are treated. However, one could glean from traditional rules and refer to my initial thoughts of it depends on what you are doing. If you're purchasing digital art, this may be deemed to fall under the IRS's definition of a collectible, which has an even higher tax rate than that of stock or other digital assets if held long-term.

WHAT SHOULD CPAs BE WARY OF CONCERNING CRYPTO WHEN ADVISING THEIR CLIENTS?

I'd say one of the most overlooked and scary compliance issues that comes up is when somebody opens a large number of accounts on various platforms. If some of those platforms are headquartered outside of the U.S., those accounts may be deemed to fall under the definition of a foreign financial institution and may be subject to the FINCEN 114 (Foreign Bank Account Reporting) filing requirements. If you miss reporting a foreign account, then you could be subject to fines and penalties of $10,000 or more for not reporting.

HOW SHOULD CPAs BE PREPARING TO DEAL WITH CRYPTOCURRENCY?

CPAs are going to run into clients opening dozens of new accounts trading new digital assets that the IRS has no guidance on. I'd recommend having a discussion with clients before year end to get a beat on what activities they've been involved with regarding crypto. Chances are if you had a client that traded crypto in 2020, they're probably on to a dozen new things in the DEFI space such as staking, liquidity pools or yield farming. What I like to ask is that the client or prospect provide a summary of all of the crypto accounts and activities. I think it's also helpful to suggest (if your client isn't already doing so) to track their crypto transactions with a third-party crypto tracking software. There are many out there that have been keeping with all the new DEFI products.

Crypto Thoughts, By Dan Herron

ON TAX REPORTING: Since there are no 1099-Bs issued (which there should be), investors don't put 2 and 2 together that they need to report their sales. We've had to amend returns because we discovered sales in prior years. There are companies that will compile the transaction into the Schedule D and Form 8949 (Cointracker, tokentax, ZenLedger, etc), which you can attach to the return, but you still need to verify the numbers from the data which the clients can extract. However, the reporting on a lot of the crypto platforms isn't quite there yet for the info we need.

ON SPENDING IT: Many people don't realize that spending crypto causes a taxable event.

ON RECEIVING IT: Is it a gift? Is it payment for services or products? Those both have different tax consequences.

ON THE WASH SALE RULE: Since crypto is treated as property, the Wash Sale Rule doesn't apply. So someone could buy and sell and then buy back again and not have to be worried about disallowed losses. Current legislation is trying to treat crypto as a security to be subject to 109-B reporting, which would be a big benefit for tax preparers in my opinion.

ON FOREIGN REPORTING: If you have a wallet or custodial accounts overseas, there's a chance that you're subject to FBAR and 8938 reporting.

ON NFTs: How do we treat this in terms of capital gains? Is it a collectible? Considering it is widely being used for artworks, the consensus so far is that the collectible capital gain rate applies. However, there's no clear guidance on this.

ON EXCHANGING IT: If you exchange one crypto for another, that's taxable.

ON TAX PLANNING: It can be difficult to tax plan if you're looking to rebalance the crypto portfolio considering how it constantly changes value.

ON VIRTUAL CURRENCY MINERS: What expenses are deemed ordinary and necessary in the course of that business? That's a new one we need to understand. If you're a miner and investor, what's the proper record keeping to make sure you are reporting transactions in an appropriate manner? If you're paying people in crypto and issuing 1099s, how do we value those payments?

ON YIELD FARMING: Make sure you report the crypto/interest received from yield farming. If you receive crypto as interest, you pay tax on that. If you then spend the crypto that you received as interest, you pay tax on that as well. There are a lot of situations where you could get double taxed. CPA

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Virtual Currency Resources

Twitter: #TaxTwitter & #Fintwit

Forbes: Crypto & Blockchain (forbes.com/crypto-blockchain)

Forbes Advisor: Crypto and Blockchain (forbes.com/newsletters/forbescryptoassetadvisor/?sh=5c736422dec8)

Tax guides and educational content for advisers/accountants:
Coindesk (coindesk.com)
Cointracker (cointracker.io)
Interaxis.IO (interaxis.io)
Onramp Invest (onrampinvest.com)
Taxbit (taxbit.com)
Zenledger (zenledger.io)

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