

New IRS Scrutiny on Cryptocurrency Reporting: Filing Requirements and Exchange Treatment

THURSDAY, FEBRUARY 15, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Cryptocurrency Reporting

February 15, 2018



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Program Outline



- Introduction
- Means of Obtaining Cryptocurrency
- Cryptocurrency Guidance
- IRS Notice 2014-21 - Tax Reporting Rules for Cryptocurrency
- Special Tax Issues for Cryptocurrency
- Potential Foreign Disclosure Requirements
- IRS Civil Examination Considerations
- IRS Criminal Investigation Considerations
- Use of Voluntary Disclosure to Get into Compliance
- Future of Cryptocurrency Enforcement
- Glossary of Key Terms

Introduction



- Cryptocurrency is drawing increased attention from government regulators.
- Coinbase, Inc. (largest virtual currency exchange) has been ordered to release information for an estimated 14,000 customers.
- Huge cryptocurrency market valuations and fluctuations.
 - \$300 to \$500 Billion Market Cap
- Some have made huge profits on cryptocurrency.
- Some are now experiencing large losses.
- There is now mainstream media attention.
- Increased acceptance by 100,000's of retail establishments.

Introduction (cont.)



- At one point, there were 100,000's of new users each week.
- In 2014, the IRS set forth rules treating Cryptocurrency as property, wherein treating it more so like currency may prove more easy to administer.
- The explosion of cryptocurrency has created challenging tax reporting issues with no further guidance from the IRS.

Types of Cryptocurrency (aka Virtual Currency)



Virtual Currencies

Bitcoin

Bitcoin Cash

Ethereum

Litecoin

900+

Exchanges

Coinbase, Inc.

Gemini

Bitfinex

Kraken

50+

Means of Obtaining Cryptocurrency (aka Virtual Currency)



- Mining
- Exchanging Virtual Currency (“VC”) for Sovereign (fiat) currency
- Exchanging VC for property (i.e. Barter)
- Exchanging VC for VC
- Hardfork/Air Drops
- Initial Coin Offerings (ICOs)

Cryptocurrency (aka Virtual Currency) Guidance



1. FinCEN's Regulations to Persons Administering, Exchanging or Using Virtual Currencies FIN-2013-G001 (March 18, 2013)
2. Virtual Economies and Currencies, GAO 13-516 (May 2013)
3. IRS Notice 2014-21 (2014)
4. AICPA Comments on Notice 2014-21 dated June 10, 2016
5. As the Use of Virtual Currencies in Taxation Become More Common, Additional Actions are Needed, TIGTA Report, Sept 21, 2016
6. US v. Coinbase, Inc. Case No 17-cv-01431, Order to Enforce IRS Summons (November 28, 2017)

Tax Reporting Requirements of Virtual Currency (IRS Notice 2014-21)



- Notice 2014 -21 describes how existing tax principles apply to transactions using virtual currency (“VC”)
- Notice 2014-21 is the only IRS position on Tax Reporting Requirements to date
- Sale or exchange or use of VC to pay for goods or service has tax consequences that may result in a tax liability.
- Gain or loss on sale of VC is gain or loss from sale of exchanges of profits, treated in a manner similar to sale or exchange of securities.

IRS Notice 2014-21 - Key Provisions



- VC is Property (Not Currency).
- Sales or exchange can produce gains or losses.
- Income from exchanging VC for goods or services is FMV of VC on date property was received (in USD).
- Basis = FMV on date currency was received (in USD).
- If FMV of property received exceeds TP's basis in VC, then TP has taxable gain (or vice versa a loss).
- Character of gain or loss depends on whether VC is a capital asset in the hands of TP. If held as investment property, the gain or loss on sale would be capital in nature.

IRS Notice 2014-21 - Key Provisions



- Employers paying VC as remuneration for services constitute wages for employment tax purposes and is subject to Federal tax withholding.
- VC Payments are subject to the same information reporting as other payments (i.e. Forms W-2, 1099, 1042 - Misc., etc.)
- Payments made by VC are subject to back-up withholding rules to the same extend as other payments.
 - Payors must solicit TIN from payees
 - Issue re: Anonymity
- Property Settlement Entities are required to report payments made to merchants to settle payments between merchants and their customers on Form 1099-K if the number of transaction exceeds 200 and the gross amount of payments made to merchant exceeds \$20,000.

Tax Reporting Requirements for Cryptocurrency Exchanges - Unresolved Issues



- **Mining Activity**
 - Does the mining of VC produce taxable income? Yes
 - Subject self-employment tax? Yes
 - Expenses associated with mining activity deductible? Should be
- **Section §1031 - Like Kind Exchanges**
 - Is exchanging VC for VC a Like-Kind Exchange (Pre-2018 Exchanges)?
 - Eliminated for Post-January 1, 2018 Exchanges (Tax Cuts and Jobs Act of 2017)
- **Treatment of Hard Forks (split into two or more VC with shared history)**
 - Is this a taxable event? Perhaps
 - Analogous to Stock Split? Not Exactly
 - New Asset with Zero Basis - Perhaps
- **Gains Subject to 3.8% Net Income Tax**
 - Probably Yes

Tax Reporting Requirements for Cryptocurrency Exchanges - Unresolved



- **Initial Coin Offerings (ICO)**
 - Is the raising of funds recognizable in income?
 - Stock offerings v. Sale of goods and services
 - What about offsetting liability?
- **AICPA Proposals for Further Guidance**
 - De minis Exception for small transactions (i.e., \$200 - similar to Currency Rule IRC §988 (e)(2))
 - Charity contribution above \$5,000 and need for Qualified Appraisal
 - VC's held by Retirement accounts
 - FBAR and Form 8938 Guidance
 - Expensing guidance for mining activity
- **ABA Comments**

Unresolved Issues



- **Accounting for Gains and Losses**
 - FIFO
 - LIFO
 - Specific Identification
- **Wash Sales Rule**
 - IRC § 1091
- **Recordkeeping Rules**
 - IRC § 6001
- **Economic Substance Doctrine**
- **Lost or Stolen Coins**
 - Casualty loss
 - Pre-Tax Cuts and Jobs Act of 2017
 - Post-Tax Cuts and Jobs Act of 2017

Unresolved Issues (cont.)



- **Timing of Gains and Losses**
 - Annual accounting concept
- **Valuation Rules**
 - How do they apply
- **Fees and Costs**
 - Schedule A
 - Pre-Tax Cuts and Jobs Act of 2017
 - Post-Tax Cuts and Jobs Act of 2017
 - Mining
- **Application of Currency Rules IRC § 988**
- **Tax Planning**
 - Expatriation IRC §877
 - Moving to Puerto Rico (Bonafide Resident)

Tips for Virtual Currency Investors



- Create a record-keeping system.
- Keep track of acquisition dates, sell dates and cost basis information
- Report dispositions on Schedule D and Form 8949.
- Identify your exchange rate.
- Use regular capital gains strategies: offset gains with losses, time dispositions to qualify for long-term treatment.
- Watch tax rates: short-term v. long-term capital rates; gains subject to the 3.8% net investment income tax.
- Be aware of tax treatment for virtual currency received by "mining" them - may be business income subject to the income tax and self-employment tax.
- Deduct any investment-related expenses (Schedule A) (Pre-Tax Cuts and Jobs Act of 2017).

Potential Foreign Disclosure Requirements - FBAR



- **Who Must File an FBAR**
 - A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds \$10,000 at any time during the calendar year.
- **Financial Account Definition**
 - A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund.

Potential Foreign Disclosure Requirements - FBAR



- Does holding VC as an Off Exchange Digital Wallet implicate the FBAR rules?
 - Probably not
 - Analogous to holding gold in a safe deposit box
 - Based on Informal Statements of IRS Personnel in 2014
- Does holding VC in an Digital Currency Exchange Account implicate the FBAR rules?
 - Perhaps
 - Location of Exchange
 - Domestic v. Foreign Servers
 - Analogous to Financial Institutions
 - FinCen would have interest in knowing
- When in doubt, disclose on FBAR.

Potential Foreign Disclosure Requirements - Form 8938



- Specified foreign financial assets include the following assets
 1. Financial accounts maintained by a foreign financial institution.
 2. Stock or securities issued by someone that is not a U.S. person
 3. Any interest in a foreign entity, and
 4. Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person
- Does VC need to be disclosed on Form 8938?
 - Not clear
 - Unless considered held by a foreign Financial Institution
- When in doubt, disclose on Form 8938

Civil Exam Considerations



- Lack of Information reporting - Form 1099K
- IRS Enforcement Staffing Dedicated to address VC
- Compliance has been Low - 800 to 900 Per Year
- Standard Audit Question Now Asking About Virtual Currency
- IRS Coinbase “John Doe” Summons
- Tax and Compliance Issues Make Reporting Difficult
- Recordkeeping by Exchanges and Holders of VC

Criminal Investigations and Prosecutions for Failing to Property Report Cryptocurrency Transactions



- CI Contract with Chainanalysis, Inc. (2017)
- Leads and Development from Examination
- Results of Coinbase John Doe Summons Enforcement

The Use of the IRS Voluntary Disclosure Policy to Get into Compliance and the Availability of “Qualified Amended Returns” to Avoid Penalties



- History of Voluntary Disclosures (“VDs”)
- Domestic VDs
- Foreign VDs
- Effectiveness of VDs
- Qualified Amended Returns and Penalty Relief
- Applicable Penalties
- Still time to correct
- **IRS Cryptocurrency is Coming!!!**

Cryptocurrency and Key Term?*



- **Cryptocurrency (or Virtual Currency)**
 - A cryptocurrency (or crypto currency) is a digital asset designed to work as a medium of exchange that uses cryptography to secure its transactions, to control the creation of additional units, and to verify the transfer of assets. Cryptocurrencies are a form of digital currencies, alternative currencies and virtual currencies. Cryptocurrencies use decentralized control as opposed to centralized electronic money and central banking systems.
- **Blockchain**
 - A blockchain, originally block chain, is a continuously growing list of records, called blocks, which are linked and secured using cryptography. Each block typically contains a cryptographic hash of the previous block, a timestamp and transaction data. By design, a blockchain is inherently resistant to modifications of the data.

Cryptocurrency and Key Term? (cont.)*



- **Digital Wallet**
 - A digital wallet refers to an electronic device that allows an individual to make electronic transactions. This can include purchasing items on-line with a computer or using a smartphone to purchase something at a store. A cryptocurrency wallet is a digital wallet where private keys are stored for cryptocurrencies like bitcoin.
- **Cryptocurrency Address**
 - A Bitcoin address, or simply address, is an identifier of 26-35 alphanumeric characters, beginning with the number 1 or 3 , that represents a possible destination for a bitcoin payment. Addresses can be generated at no cost by any user of Bitcoin.

Cryptocurrency and Key Term? (cont.)*



- **Mining Virtual Currency**
 - In cryptocurrency networks, mining is a validation of transactions. For this effort, successful miners obtain new cryptocurrency as a reward. The reward decreased transaction fees by creating a complementary incentive to contribute to the processing power of the network
- **Digital Currency Exchanges**
 - Cryptocurrency exchanges or digital currency exchanges (DCE) are businesses that allow customers to trade cryptocurrencies or digital currencies for other assets, such as conventional fiat money, or different digital currencies. They can be market makers that typically take the bid/ask spreads as transaction commissions for their services or simply charge fees as a matching platform.
- **Hard Fork**
 - A hard fork occurs when a blockchain splits into two incompatible separate chains. This is a consequence of the use of two incompatible sets of rules trying to govern the system

Cryptocurrency and Key Term? (cont.)*



- **Airdrop**
 - An airdrop for a cryptocurrency is a procedure of distributing tokens by awarding them to existing holders of a particular blockchain currency, such as Bitcoin or Ethereum. In the United States, the practice has raised questions about tax liabilities and whether they amount to income or capital gains.
- **Initial Coin Offering**
 - An initial coin offering (ICO) is a means of crowdfunding centered around cryptocurrency, which can be a source of capital for startup companies. In an ICO, a quantity of the crowdfunded cryptocurrency is preallocated to investors in the form of "tokens," in exchange for legal tender or other cryptocurrencies such as bitcoin or ethereum. These tokens supposedly become functional units of currency if or when the ICO's funding goal is met and the project launches.

*Definitions obtained from <https://www.wikipedia.org/>



Be Prepared. . .

IRS cryptocurrency enforcement is coming!!!!

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