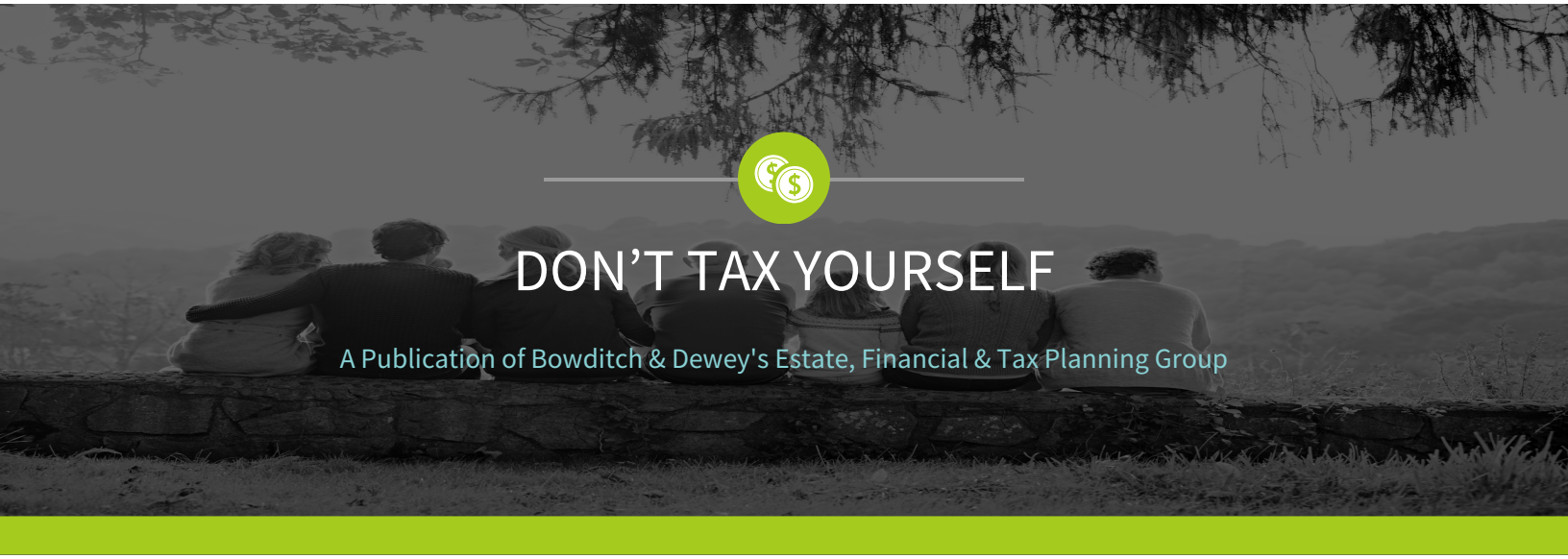

Cryptocurrency Tax Update

BY BOWDITCH & DEWEY • JUNE 23, 2021

The IRS continues its campaign against cryptocurrency investors and traders who evade income taxes on currency gains. As we wrote in 2016, the IRS was successful in compelling Coinbase, a large digital currency exchange, to turn over customer information on cryptocurrency trades. As a result of its litigation success, the IRS wrote notices to 10,000 taxpayers regarding their cryptocurrency tax reporting and as a result:

- received more than 1,000 amended tax returns;
- collected $13 million in taxes from crypto holders with more than $20,000 of transactions;
- and collected another $12 million from other crypto notices.

In April 2021, a Boston federal judge approved an IRS summons to Circle and its affiliates to turn over customer records of cryptocurrency trades. In May 2021, a federal judge in San Francisco approved another IRS summons for customer records to the Kraken crypto exchange.

President Biden, in his fiscal year 2022 budget, has proposed additional IRS funding to enforce tax compliance for cryptocurrency transactions. Moreover, the Treasury Department has recently released the "American-Families-Plan-Tax-Compliance-Agenda," which proposes a new financial institution reporting regime. In this reporting regime, all financial institutions, including foreign financial institutions, crypto asset exchanges, and custodians, must report gross inflows and outflows on all business and personal accounts to the IRS. Such reporting would apply to all bank, loan, and investment accounts. The Treasury carves out an exception for accounts below a low de minimis gross flow threshold. The Treasury also proposes that businesses that receive cryptoassets with a fair market value of more than $10,000 must report these transfers to the IRS. This second proposal addresses the increasing use of crypto currencies in ordinary business transactions.

The IRS issued guidance in 2014 outlining how general federal tax principles apply to transactions using virtual currencies. See Notice 2014-21 and the previously mentioned blog post for more information. For federal tax

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purposes, virtual currency is treated as property, not foreign currency. Therefore, if a taxpayer uses virtual currency to pay for other property in a business transaction (such as paying for business supplies), the taxpayer must treat the transfer of virtual currency to pay for the supplies as a sale of property (recognizing gain or loss on the currency's change in value).

The type of gain (or loss) will depend on whether the virtual currency is a capital asset in the hands of the taxpayer. For many taxpayers, virtual currency will be a capital asset and any resulting gains or losses will be capital and either short or long-term using federal tax principles.

In Revenue Ruling 2019-24, the IRS ruled that any taxpayer that receives new units of cryptocurrency as a result of an air drop following a "hard fork" of the cryptocurrency will recognize ordinary income on the new currency's receipt. This income recognition occurs whether or not the taxpayer disposes of the air dropped currency after receipt.

With the complexity of the tax treatment of cryptocurrency and proposed crypto reporting requirements, you should talk with your tax adviser if you engage in any cryptocurrency transactions.

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