

Virtual Currency Ventures: Navigating Tax and Accounting Waters for Success

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Step into the fascinating world of virtual currencies, where digital marvels like Bitcoin and Dogecoin, have captured the attention of adventurers and investors alike. As you venture into this dynamic realm, it's important to understand the tax and accounting maze that accompanies these alluring assets. To help, here's an overview of some intricacies of virtual currency transactions and how they are impacted by our tax laws.

The Internal Revenue Service (IRS) has taken the stance that virtual currencies are generally considered property, rather than traditional currency. This means that even though virtual currencies function similarly to traditional currencies, including their use in transactions for goods, services, and even as investments, they are treated for tax purposes as capital assets—like stock.

For federal income tax purposes, the general rules for calculating gains and losses for capital assets apply to virtual currency. The cost basis for your property is typically the fair market value of the asset as of the date you received it. This includes virtual currency that you bought or traded. When you sell or otherwise dispose of virtual currency, you'll report your gain or loss, just as you would with any other capital asset.

Let's look at a few examples. Suppose you purchased Bitcoin valued at \$100 for \$100. Because the value of the currency was \$100 when you purchased it, your cost basis in the Bitcoin is \$100. If you later sell the Bitcoin for \$150, you will recognize a capital gain of \$50 (amount realized from sale of \$150 less cost basis of \$100). If you instead sell the Bitcoin for \$50, you will recognize a capital loss of \$50 (amount realized from sale of \$50 less cost basis of \$100).

Keep in mind that while cryptocurrency that is mined or acquired as payment for goods or services, is taxable as ordinary income upon receipt, it will still result in a capital gain or loss upon disposal if the cost basis does not equal the amount realized from the sale. Suppose you receive \$100 worth of Bitcoin as payment for services rendered. You will immediately incur an ordinary income tax liability on \$100, and your cost basis for capital asset purposes will be \$100. If you later dispose of the Bitcoin, the usual capital asset rules will apply.

The same general rules apply to other types of digital assets, like Non-Fungible Tokens (NFTs) or digital collectibles. If you receive virtual currency as a gift, your basis will be the same as it was in the hands of the person who made the gift. And you'll receive a step-up in basis for any asset you receive after the death of a decedent.

The IRS has been paying close attention to virtual currency transactions and has emphasized the importance of properly reporting them. You'll see a question about virtual currency on the front page of your tax return—if you are buying, selling, trading, or mining virtual currency like Bitcoin, even as a novelty, be sure to pay attention to that question and discuss it with your tax professional. Failure to report virtual currency transactions can lead to penalties, interest, and even criminal prosecution in certain situations.

Currently, the burden of reporting virtual currency falls to the owners—there are few transactions with mandatory reporting by third parties, although that may be changing. The Infrastructure Investment and Jobs Act, enacted in 2021, aims to enhance reporting and enforcement of virtual currency transactions. The Act broadens the definition of a “broker” to include those who facilitate transfers of digital assets. Brokers are now required to file Forms 1099-B, similar to reporting requirements for stocks and bonds. Additionally, the Act includes cash receipt provisions that become effective in 2024, which encompass digital assets. This means that individuals or businesses receiving more than \$10,000 in digital assets must file an information return, similar to the reporting requirements for cash transactions.

The Financial Accounting Standards Board (FASB), which establishes financial accounting and reporting standards for public and private companies, has yet to issue specific guidance on virtual currencies. The FASB is currently researching this area but has not formally discussed the topic. Similarly, the Securities and Exchange Commission is grappling with how to treat virtual currencies. A number of cases are winding through the courts right now, including a highly publicized fight with Coinbase accusing the platform of operating an unregistered exchange and broker.

It’s clear that the world of virtual currency is going to continue to evolve, especially as the government expresses more interest in regulating and taxing it. To ensure compliance and minimize risks associated with virtual currency transactions, we recommend that you seek guidance from a tax professional and stay updated on regulatory developments. Our firm’s tax department is equipped to provide the necessary expertise and assistance in navigating the complexities of virtual currency transactions.

Should you have any questions or require further information regarding this matter or any other tax-related concerns, please do not hesitate to contact Kelly Phillips Erb at erbk@whiteandwilliams.com; 215.864.7186 or Jonah S. Levinson at levinsonj@whiteandwilliams.com; 215.864.7194, or any member of the Tax and Estates Group.

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