

# **HELP! – MY CLIENT HAS CRYPTOMANIA!**

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## **I. WHAT IS CRYPTOCURRENCY**

- A. Block chain technology is the underlying technology of cryptocurrencies
- B. Bitcoin, Ethereum and Litecoin
- C. Blockchain technology is the use of a highly encrypted, fixed or immutable distributed ledger which is authenticated by a peer-to-peer network
- D. Created in 2008
- E. Allows online payment to be sent from one party to another without going through a financial institution
- F. Creates a network of time stamped transactions that cannot be changed
- G. Cryptocurrency is mined by a powerful computer program

## **II. TERMINOLOGY (FROM IRS DEFINITIONS)**

- A. Bitcoin – a form of cryptocurrency. For purposes of this outline, bitcoin is used generically to represent all forms of cryptocurrency
- B. Blockchain – the technology underlying cryptocurrencies
- C. Distributed ledger technology - uses independent digital systems to record transactions, the details of which are recorded in multiple places at the same time with no central data storage locator

- D. Hard fork – occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or the existing distributed ledger
  - 1. may result in creation of new cryptocurrency on a new ledger in addition to the legacy cryptocurrency
  - 2. transactions involving the new cryptocurrency are recorded on a new ledger
- E. Air drop – a means of distributing units of cryptocurrency to the ledger addresses of multiple parties
- F. Key – the means to access the cryptocurrency
- G. Wallet – storage of the cryptocurrency

### III. WHY DO I CARE ABOUT CRYPTOCURRENCY?

- A. Because clients are using them for business and personal transactions.
- B. Because clients are buying cryptocurrencies as an investment

### IV. CURRENCY OR PROPERTY

- A. Arguments for Currency
  - 1. Circulates
  - 2. Accepted as payment for goods
  - 3. Used and accepted as a medium of exchange
  - 4. IRS definition of virtual currency – functions like government issued legal tender
- B. Effects of Treating Cryptocurrency as Property

1. Gain or loss on use – capital or ordinary
2. No like kind exchanges
3. Miner of bitcoins - income
4. Investor versus trader

C. SEC – Security

D. Commodity

V. IRS POSITION

A. IRS Notice 2014 – 21, 2014-16 IRB 938

1. Ruling issued in March 2014
2. Applies general tax principles to cryptocurrency
3. IRS ruled that cryptocurrency is treated as property for tax purposes and not as currency.
4. Receipt of bitcoins for services rendered is ordinary income based on the fair market value of the bitcoins
5. Payment for goods and services – if using bitcoins, will have gain or loss based on value of bitcoins transferred in excess of the basis of the bitcoins
6. Basis of the cryptocurrency is the amount paid for the bitcoins, or the fair market value of bitcoins received for goods or services as of the date of receipt
7. Basis – cryptocurrency exchanges can be used to determine fair market value

8. Example –

Taxpayer delivers \$10,000 worth of bitcoin to purchase a painting. If the taxpayer's basis in the bitcoins was \$2,000, the taxpayer has a taxable gain of \$8,000 in connection with this transaction

9. Payment of wages by payment by bitcoin is subject to normal employment tax rules – i.e., withholding, FICA, FUTA, etc.

B. Recent Pronouncement

1. Commentators have been waiting for further guidance from IRS regarding the use of cryptocurrency
2. IRS Notice 2018-71, March 23, 2018. IRS reminded taxpayers that income from virtual currency transactions is reportable on income tax returns.
3. Failure to properly account for cryptocurrency transactions can subject the taxpayer to civil or criminal penalties
4. IRS issued Revenue Ruling 2019-24 and Frequently Asked Questions (FAQ) on October 9, 2019

C. Revenue Ruling 2019-24, 2019-44 IRB 1

1. Not as broad as many people hoped
2. Clarified the rules for tax treatment of hard forks and air drops
3. IRS ruled that a hard fork will not create taxable income if the taxpayer does not receive new units of cryptocurrency
4. An air drop following a hard fork will generate taxable income to the taxpayer

5. Example –

Situation 1 – Brian holds 50 units of Crypto M, a currency, on October 1, 2019. Crypto M experiences a hard fork creating Crypto N. Brian does not receive any units of Crypto N and his ownership of crypto M is not changed. No tax consequences to Brian as a result of the hard fork.

Situation 2 – Jeff owns 50 units of Crypto R. On June 1, 2020, Crypto R experiences a hard fork and creates Crypto S. Jeff receives 25 units of Crypto S. Jeff has ordinary income for the value of Crypto S received.

D. FAQ's (43 questions and answers)

1. Expand on the information provided in Notice 2014-21, and apply the same tax principles
2. Basically, a taxpayer will have gain or loss using bitcoins to pay for property, and will have income upon the receipt of bitcoins
3. Based on fair market value of the bitcoins when transferred or received
4. Gain or loss is based on the difference between the fair market value of the bitcoins transferred and the basis of the bitcoins
5. Taxpayers can identify specific units of bitcoin and substantiate the basis in those units
6. If not specifically tracked, taxpayers are deemed to have sold the units on a first in – first out (FIFO) basis

7. Capital gains and losses from virtual currency transactions are reported on Form 1040, Schedule D and Form 8949, Sales and Other Dispositions of Capital Assets

E. IRS Investigation

1. IRS is aware that some taxpayers may have failed to report income and pay the resulting tax or did not report their transactions properly
2. IRS actively addressing potential non-compliance
3. IRS mailed out 10,000 letters in July to taxpayers who may have reported transactions involving cryptocurrency incorrectly or not at all
4. IRS also issued subpoenas to Coinbase for information regarding transactions by their customers
5. IRS Large Business and International Division has issued notices that they will be reviewing for virtual currency transactions in connection with their audits
6. IRS is also stepping up training of revenue agents and revenue officers regarding cryptocurrencies
7. New question being added to Form 1040, Schedule 1

At any time during 2019, did you receive, sell  
send, exchange or otherwise acquire any  
financial interest in any virtual currency?

8. Congressional Regulation –

Bills pending to regulate virtual currencies on these topics:

- a. Crime Prevention & Detection
- b. National Security & Terrorism
- c. Regulatory Certainty
- d. Consumer Protection
- e. U.S. Competitiveness & Economic Prosperity
- f. Taxation

VI. ESTATE PLANNING ISSUES – CRYPTOCURRENCY

- A. Need disclosure to CPA and estate planning attorney
  - Cannot protect it if don't know about it
- B. Who owns it – title in Trust?
- C. How do we get access?
  1. Anonymous
  2. Private key –
    - access to password
    - copy of password to someone
  3. Quadriga case
- D. Ownership by Fiduciary of Estate – prudent investor rule

VII. ESTATE PLANNING ISSUES – DIGITAL ASSETS

- A. Types of digital assets
  1. Website

2. Domain name
  3. Social media – Gmail, Facebook, Linked In, etc.
  4. Facebook or You Tube Channel
  5. Bank and other financial records
- B. Disclosure of contents of digital account
- C. Access to passwords
- D. Fiduciary Access to Digital Assets Act (FADAA) – Michigan statute
1. Procedures to allow access to digital assets
  2. Can name a “Digital Executor” – in estate plan documents, or in separate writing
- E. Online Option Tools –
- Google
  - Facebook
- F. Third party service providers for digital asset directives management
- G. Have digital assets owned by an LLC if business related

## VIII. CRYPTOCURRENCY AS A RETIREMENT PLAN INVESTMENT

- A. Allowable as an investment
- B. Many risks
- Volatility
  - Valuation issues



- Prudent investment
- Security risk – hackers
- Record keeping
- Future government regulation