One topic gaining much attention from many clients is Virtual Currency (VC), specifically the tax treatment of VC transactions. We have put together a brief summary with some important points to consider as we wrap up this tax year.

Virtual Currency ***is not currency*** in the eyes of the IRS. VC in its many forms is considered property. Most rules governing the tax treatment of property apply. VC that is traded, purchased and sold, is treated very much like the buying and selling of stock. For instance, the short term and long term holding periods for stock also apply to VC.

VC can also be earned through a variety of different activities, loans, mining, etc. In these cases VC is considered income upon receipt, at the FMV on that date (tax dependent on type of income, more below). The value upon receipt becomes the adjusted cost basis. Proceeds upon sale (less the adjusted basis) is capital gain income and subject to same tax rates as other property sales.

The tricky part with VC is often determining and tracking the cost basis. While tedious, tracking the cost basis is crucial for several reasons. Without proper basis tracking, it is essentially impossible to utilize any financial strategy. Additionally, the IRS and state tax agencies are drilling down hard on VC sales and require detailed accounting records in the event of review.

There are generally three main accounting methods associated with VC sales. They are:

1) FIFO – first in, first out – assumes you are selling the oldest coins/fraction of coins first
   - Considered most conservative approach, preferred by the IRS
   - Easiest to maintain over time – doesn't require specific identification of coins sold the way the specific ID methods do
   - Most likely to allow for more LT cap gain sales subject to preferential tax rates
2) LIFO* – last in, first out – assumes you sell the most recently obtained coins/fractions of coins first
   - Most likely to be short term and therefore taxed as ordinary income
   - Requires detailed tax basis records of specifically identified coins
   - Depending on price history might trigger less tax than other methods
3) HIFO* – highest in, first out – sell off the coins/fractions of coins with highest cost basis first
   - Similar to LIFO
   - Also requires detailed basis records identifying specific coins sold
   - Method prioritizes tax savings over investment strategy

The one method we do not advocate is LAFO – Let Accountant Figure Out

**These methods are considered "specific ID" methods*. This means the specific coins/fraction of coins need to be clearly identified upon sale. Examples of clear ID information includes specific unit digital identifier, such as private key, public key, address, etc.

The IRS does allow for changes in accounting methods – you don't have to maintain one consistently. However, ***switching methods is often where the errors occur***. Also, records must be meticulous. There is substantially higher risk of audit by making the change.

<u>Tax Forms/information needed for different types of VC transactions</u>

Sold VC during the 2021 tax year?

- IRS Form 8949– detailed schedule attached to Schedule D
  - This can be generated by most all the crypto management software available
  - Contains the quantity sold, when they were obtained, adjusted cost basis and sales proceeds

Received VC as payment for services/goods?

- FMV in USD on the date the payment was received
- If sold, need the same information described above

Purchased VC?

- Only purchased, no taxable event, no reporting required until sold

Received VC for mining/staking activities

- FMV in USD on the date the payment was received
- If sold, need the same information described above
- This is considered self-employment income, so expenses incurred as a result can be used to offset some of the income

Used VC to pay independent contractors in a business transaction?

- Keep records regarding value of VC paid
- Issue 1099s if you pay at least $600 to any contractors

While this might sound a bit overwhelming, the good news is most VC software out there will do much of the work for us. They can merge all your VC holdings in one place, generate the needed tax forms and even model out tax consequences of selling coins using the different accounting methods.

> ***We like ZenLedger***. *You can link your VC holdings from Coinbase. There are several pricing options, but even the more basic options have the ability to generate the tax forms and model out expected capital gains using different accounting methods. It also offers the ability to invite an accountant (us) to view your account information and print reports to be used for tax preparation and tax planning purposes.*

In our view, utilizing one of these digital accounting systems, be it ZenLedger or any other one, is more than helpful; it has become essential. As the volume and complexity of VC trades has dramatically increased so has the IRS scrutiny. We are raising this issue at this time for a very practical reason. Once the new year begins, and we start to work on preparing tax returns, there are time constraints. We simply will not have the ability to work through and decipher our clients' VC activity. **We are going to require that the complete 2021 Form 8949 is provided to us along with other tax forms as we prepare the 2021 tax returns.**

We do stand by and are ready to help organize your VC data at this time. Please reach out if you have questions about how best to organize your 2021 VC transactions. We can discuss implications of using different accounting methods, tax loss harvesting, prepare tax projections or any other nuances related to VC transactions. Again, this is when to schedule some time with us.