

Cryptocurrency: Tax and Estate Planning

Boulder County Estate Planning Council

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IRS GUIDANCE



IRS Notice 2014-21

- Describes how existing general tax principles apply to transactions using virtual currency.

Revenue Ruling 2019-54

- Determines whether a taxpayer has gross income under § 61 as a result of:
 1. A “hard fork” of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency.
 2. An “airdrop” of a new cryptocurrency following a hard fork if the taxpayer receives new cryptocurrency.

General Tax Principles

IRS Notice 2014-21 and IRS FAQs

IRS Notice 2014-21 describes the general taxation of Bitcoin through 16 FAQs.

The IRS has expanded on the list of FAQs and posted them on their website, and there are currently 46 FAQs.

<https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions>

Unless otherwise noted, the FAQs assume that the taxpayer holds virtual currency as a capital asset.

Virtual Currency

Definition

“Virtual Currency” is a digital representation of value, other than a representation of the U.S. dollar or a foreign currency (“real currency”), that functions as a unit of account, store of value, and a medium of exchange.

Some virtual currencies are convertible, which means that they have an equivalent value in real currency or act as a substitute for real currency (“convertible virtual currency”).

The IRS uses the term “virtual currency” in the FAQs to describe various types of convertible virtual currency that are used as a medium of exchange, such as digital currency or cryptocurrency. *IRS FAQs, Q&A 1*

Bitcoin is one example of a convertible virtual currency. *IRS Notice 2014-21, § 2*

Cryptocurrency

Definition

“Cryptocurrency” is a type of convertible virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger such as a blockchain.

IRS FAQs, Q&A 1

“Cryptography” means the computerized encoding and decoding of information.

Merriam-Webster Dictionary

General Tax Principles

Property Taxation

Q2. How is virtual currency treated for Federal income tax purposes?

A2. Virtual currency is treated as property and ***general tax principles applicable to property transactions*** apply to transactions using virtual currency. For more information on the tax treatment of property transactions, see Publication 544, Sales and Other Dispositions of Assets.

Amount Realized – Adjusted Basis = Gain or Loss

Recognition of Gain or Loss

Capital Gain or Loss

Q4. Will I recognize a gain or loss when I sell my virtual currency for real currency?

A4. Yes. When you sell virtual currency, ***you must recognize any capital gain or loss*** on the sale, subject to any limitations on the deductibility of capital losses.

If a taxpayer pays for goods or services using a virtual currency that the taxpayer holds as a capital asset, then the taxpayer has exchanged a capital asset for those goods or services and will have a capital gain or loss. *IRS FAQs, Q&A 14, Q&A 16*

Note: In some instances, virtual currency may be treated as inventory (instead of a capital asset) if it is held for sale to customers in a trade or business.

Recognition of Gain or Loss

Capital Loss Limitations

Capital losses may only be deducted from capital gains.

Individuals and other Noncorporate Taxpayers:

- Up to \$3,000 of capital losses may be deducted from ordinary income
- No carryback for net capital losses
- Net capital losses carried forward indefinitely

Corporate Taxpayers:

- Net capital losses carryback 3 years
- Net capital losses carryforward 5 years

IRC §§ 1211, 1212, 1222

Recognition of Gain or Loss

Determining Basis

The adjusted basis of virtual currency is determined in accordance with IRC §§ 1011, 1012 and 1016

Q8. How do I calculate my gain or loss when I sell virtual currency for real currency?

A8. Your **basis** (also known as your “**cost basis**”) is the amount you spent to acquire the virtual currency, including fees, commissions and other acquisition costs in U.S. dollars. Your **adjusted basis** is your basis increased by certain expenditures and decreased by certain deductions or credits in U.S. dollars.

Recognition of Gain or Loss

Determining Basis

If a taxpayer sells property in exchange for virtual currency, the taxpayer's basis in the virtual currency is the fair market value of the virtual currency, in U.S. dollars, when the virtual currency is received.

The taxpayer will recognize gain or loss on the property that was exchanged for the virtual currency (i.e., the adjusted basis of the property does not carryover to the virtual currency).

IRS FAQs, Q&A 21

Recognition of Gain or Loss

Determining Fair Market Value of Cryptocurrency Received

Cryptocurrency Exchange: The FMV is the amount that is recorded by the cryptocurrency exchange for that transaction in U.S. dollars. If the transaction is off-chain, or not recorded on the distributed ledger for some other reason, then the FMV is the amount the cryptocurrency was trading for on the exchange at the date and time the transaction would have been recorded on the ledger if it had been an on-chain transaction.

Peer-to-Peer Transaction: The FMV is determined as of the date and time the transaction is recorded on the distributed ledger, or would have been recorded on the ledger if it had been an on-chain transaction. The IRS will accept as evidence of FMV the value as determined by a cryptocurrency or blockchain explorer that analyzes worldwide indices of cryptocurrency and calculates the value of the cryptocurrency at an exact date and time. **If the taxpayer does not use an explorer value, the taxpayer must establish the value used is an accurate representation of the cryptocurrency's FMV.**

IRS FAQs, Q&A 26, Q&A 27

Recognition of Gain or Loss

Identifying Units of Virtual Currency – Different Basis Amounts

A taxpayer may choose which units of virtual currency are deemed to be sold or exchanged if: (a) the taxpayer can specifically identify which units of virtual currency are involved in the transaction, and (b) substantiate basis for those units.

If the taxpayer does not specifically identify the units of virtual currency, the units are deemed to have been sold or exchanged on a **first in, first out (FIFO) basis**.

IRS FAQs, Q&A 39, Q&A 40, Q&A 41

Compensation

Compensation Paid in Virtual Currency is Ordinary Income

Receiving virtual currency in exchange for the performance of services results in the recognition of ordinary income.

Employees: Treated as wages reported on Form W-2.

Independent Contractors: Treated as self-employment income.

The amount of income recognized is the FMV of the virtual currency when the virtual currency is received.

The service provider's basis in the virtual currency is the FMV of the virtual currency when the virtual currency is received.

IRS FAQs, Q&A 9, Q&A 10, Q&A 11, Q&A 12, Q&A 13

Passive Activity Losses

Actively Traded Personal Property

A trading activity of trading personal property for the account of owners of interests in the activity is not a passive activity, without regard to whether such activity is a trade or business activity. Personal property is any personal property that is actively traded within the meaning of IRC § 1092 (for example, financial securities). Temp. Reg. § 1.469-T(e)(6); IRS Publication 925.

“Actively traded personal property” includes any personal property for which there is an established financial market. *Treas. Reg. § 1.1092(d)-1.*

The IRS has not issued guidance on this issue, but commentators believe that Bitcoin is likely to be actively traded personal property because Bitcoin futures contracts trade on the Chicago Mercantile Exchange (CME) and ICE Future U.S. (IFUS).

Worthlessness or Abandonment Deduction

Chief Counsel Advice 202302011

Taxpayer who owned digital asset/cryptocurrency that declined substantially in value did not sustain loss under IRC § 165 due to worthlessness or abandonment where taxpayer had maintained ownership of cryptocurrency through end of stated year, and it had liquidating value. And, even if taxpayer did sustain an IRC § 165 loss, such loss would be disallowed because IRC § 67(g) suspended miscellaneous itemized deductions for years 2018 through 2025.

- Taxpayer bought “Cryptocurrency B” in 2022 for \$1.00 per unit for personal investment on cryptocurrency exchange. At the end of 2022, each unit was valued at less than \$0.01.
- As of December 31, 2022, Cryptocurrency B continued to be traded on at least one cryptocurrency exchange.
- Taxpayer maintained ownership and control of the units through 2022.

Worthlessness or Abandonment Deduction

Chief Counsel Advice 202302011

Abandonment

A loss is treated as sustained in the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. *Treas. Reg. 1.165-1(d)(1)*.

The mere diminution in value of property does not create a deductible loss. An economic loss in value of property must be determined by the permanent closing of a transaction with respect to the property. A decrease in value must be accompanied by some affirmative step that fixes the amount of the loss, such as abandonment, sale, or exchange.

Taxpayer A did not take any action to abandon and permanently discard Taxpayer A's units of Cryptocurrency B during 2022. Abandonment is proven through an evaluation of the surrounding facts and circumstances, which must show: (1) an intention to abandon the property, coupled with (2) an affirmative act of abandonment.

Worthlessness or Abandonment Deduction

Chief Counsel Advice 202302011

Worthlessness

A loss may be sustained if cryptocurrency becomes worthless, resulting in an identifiable event that occurs during the tax year, even though the taxpayer did not relinquish title to the cryptocurrency. Whether an asset becomes worthless is a question of fact.

In this case, each unit of Cryptocurrency B had liquidating value, though it was valued at less than \$0.01 at the end of 2022. Cryptocurrency B continued to be traded on at least one cryptocurrency exchange, allowing for the possibility that it may increase in value in the future. Accordingly, Cryptocurrency B was not wholly worthless during 2022 as a result of its decline in value, and the taxpayer did not sustain a bona fide loss under section 165(a) in 2022 due to worthlessness

Charitable Contributions

Amount of Deduction

Treated in the same manner as donations of appreciable property.

Held for More than 1 Year: FMV of the virtual currency at the time of donation.

Held for One Year or Less: Lesser of (a) FMV at time of donation, and (b) basis in the virtual currency

IRS FAQs, Q&A 34, Q&A 35

Charitable Contributions

Donation of More than \$5,000

Chief Counsel Advice 202302012

1. Is Taxpayer A required to obtain a qualified appraisal under IRC § 170(f)(11)(C) for contributions of cryptocurrency for which Taxpayer A claims a charitable contribution deduction of more than \$5,000?
2. If Taxpayer A is required to obtain a qualified appraisal under IRC § 170(f)(11)(C) and fails to do so, does the reasonable cause exception provided in IRC § 170(f)(11)(A)(ii)(II) apply if Taxpayer A determines the value of the cryptocurrency based on the value reported by a cryptocurrency exchange on which the cryptocurrency is traded?

Charitable Contributions

Donation of More than \$5,000

Chief Counsel Advice 202302012

FACTS: Taxpayer A donated units of “Cryptocurrency B” to a charity and claimed a charitable deduction of \$10,000. The claimed \$10,000 deduction was based on a value listed at the cryptocurrency exchange on which Cryptocurrency B was traded at the date and time of the donation. Taxpayer A did not obtain, or attempt to obtain, a qualified appraisal for the donation. Taxpayer A argued that no appraisal is required because Cryptocurrency B had a readily ascertainable value based on the value published by the cryptocurrency exchange.

Charitable Contributions

Donation of More than \$5,000

Chief Counsel Advice 202302012

Exception to Appraisal Requirement: A qualified appraisal is not required for “publicly traded securities”.
IRC § 170(f)(11)(A)(ii)(I).

A “publicly traded security” is defined in IRC § 165(g)(2) as a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form.

The CCA determines that **Cryptocurrency B is not a publicly traded security** within the meaning of IRC §§ 170(f)(11) or 165(g)(2), and thus the exception does not apply.

Charitable Contributions

Donation of More than \$5,000

Chief Counsel Advice 202302012

Failure to acquire a qualified appraisal will not result in the denial of the deduction if it is shown that the failure to meet such requirements is due to reasonable cause and not willful neglect. *IRC § 170(f)(11)(A)(ii)(II)*.

The reasonable cause exception was not intended to provide taxpayers with the choice of whether to obtain a qualified appraisal, but to provide relief where an unsuccessful attempt was made in good faith to comply with the requirements of *IRC § 170*. *Pankratz v. Commissioner*, T.C. Memo 2021-26.

Here, the taxpayer did not attempt to comply with the appraisal requirement. As such, **claims that Cryptocurrency B has a readily ascertainable value because it is listed on a cryptocurrency exchange does not establish reasonable cause for failing to obtain, or attempting to obtain, a qualified appraisal.**

Transfers at Death

Basis Step-Up

Cryptocurrency owned by the decedent at death will receive a basis step-up to the FMV of the cryptocurrency on the date of death.

Note: Transferring cryptocurrency to an irrevocable trust will prohibit a basis step-up at the grantor's death.

Transfers at Death

Probate

Cryptocurrency will be a probate asset. Cryptocurrency exchanges do not current appear to provide “transfer on death” beneficiary designations.

For trustees and executors accessing the decedent’s digital accounts and wallets, the rules under the Revised Uniform Fiduciary Access to Digital Asset Act (RUFADAA) will apply.

Transfers at Death

Estate Planning Recommendations

1. Tracking

- Basis
- Login credentials for cryptocurrency exchanges

2. Estate Planning Documents

- Consider adding or updating RUFADAA provisions to guide executors and trustees
- Add a schedule to track the locations where cryptocurrency is stored

Reporting Requirements

Individuals

Form 1040 asks:

At any time during 2023, did you: (a) receive (as a reward, award or payment for property or services); or (b) sell, exchange, gift or otherwise dispose of a digital asset (or a financial interest in a digital asset)?

Taxpayers may answer “no” if their activities were limited to purchasing virtual currency with real currency.

IRS FAQs, Q&A 5

Reporting Requirements

Brokers

IRC § 6045 requires brokers to file information returns.

Section 80603 of the Infrastructure Investment and Jobs Act, Pub. L. No. 117-58 , 135 Stat. 429, 1339 (2021) (Infrastructure Act) provides the definition of “broker” includes a person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.

Reporting Requirements

Brokers

IRS Announcement 2023-2, 12/23/2022

Once final regulations are issued, the definition of “broker” will include a person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.

The Treasury Department and IRS will go through a notice and comment period, publish forms and instructions, and issue final regulations before the new rules under the Infrastructure Act tax effect.

The reporting requirement was originally set to take effect for transactions occurring on or after January 1, 2023.

Reporting Requirements

Brokers

IRC § 6045

Every person doing business as a broker shall make a return showing the name and address of each customer, with such details as gross proceeds and such other information as the Treasury Department may require.

Brokers must also furnish a payee statement to customers and report the adjusted basis of a customer's securities.

Questions?