Taxation of digital assets:
Bringing clarity to complexity

Managing tax uncertainty around digital assets

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PRESENTED BY:
Trudie Kanter

Presenter

Trudie Kanter, CPA

Partner

A trusted tax adviser and blockchain enthusiast, with over 17 years of experience at Crowe in the financial services industry.

Trudie specializes in the taxation of virtual currency and is a frequent contributor to industry publications.

Course objectives

1

Describe key components of digital assets,
such as blockchains, crypto assets, and wallets

2

Identify the tax treatment and tax consequences
of transactions involving digital assets

3

Review the existing tax guidance for virtual currency

Agenda

This course will address 3 main topics:

1

Introduction: 5 minutes

2

Digital assets overview and concepts: 30 minutes

3

Understanding the tax treatment: 25 minutes

Digital assets overview and concepts

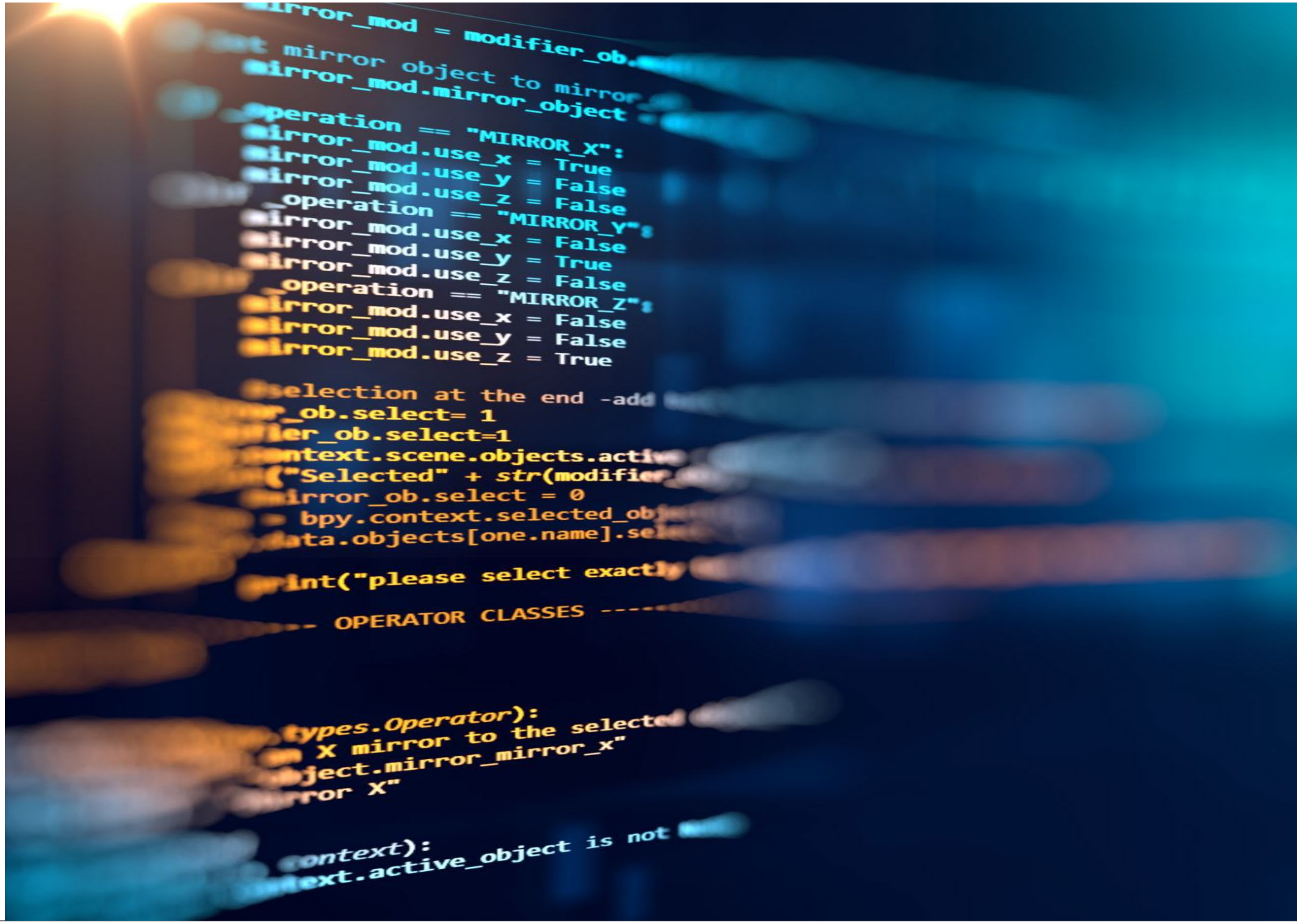
e.g., blockchain, wallets

Key terms in the crypto universe

Blockchain technology	Blockchain protocol	Types of blockchains	Consensus mechanism	Fiat
Cryptography	Digital asset	Crypto asset	Cryptographic key	Gas fee
Node	Digital wallet	Smart contracts	Distributed ledger	Immutability

Finding where crypto can take you **starts with understanding the basics**

- Blockchain
- Distributed ledger technology
- Digital assets
- Crypto assets
- Wallets



Blockchain

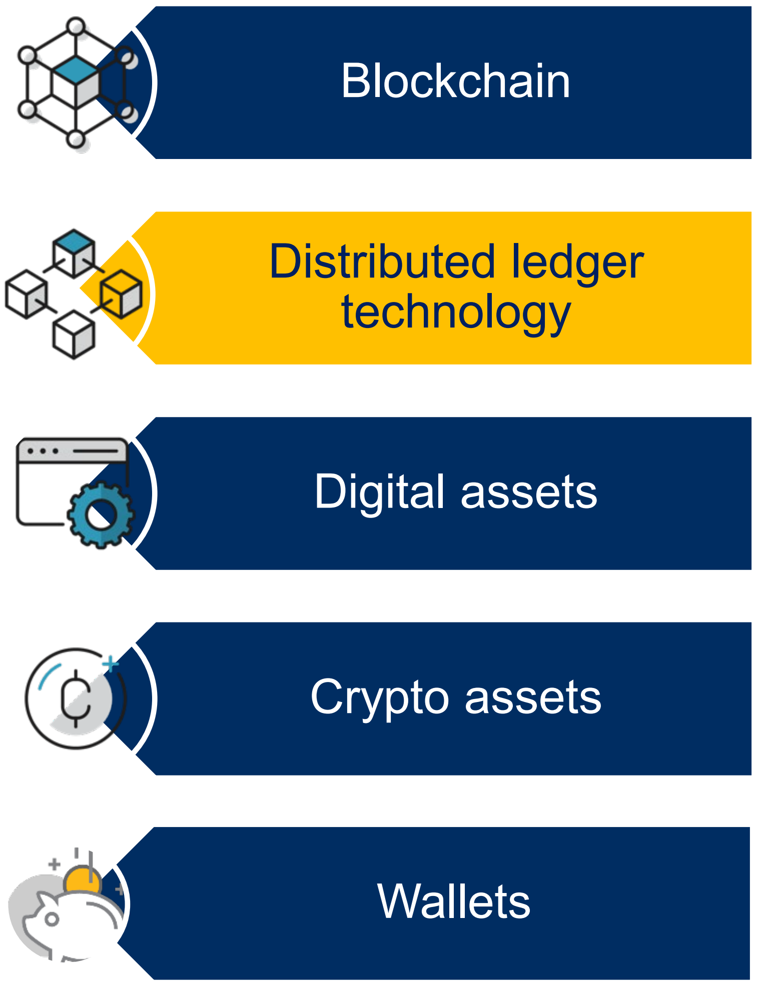
- Blockchain
- Distributed ledger technology
- Digital assets
- Crypto assets
- Wallets

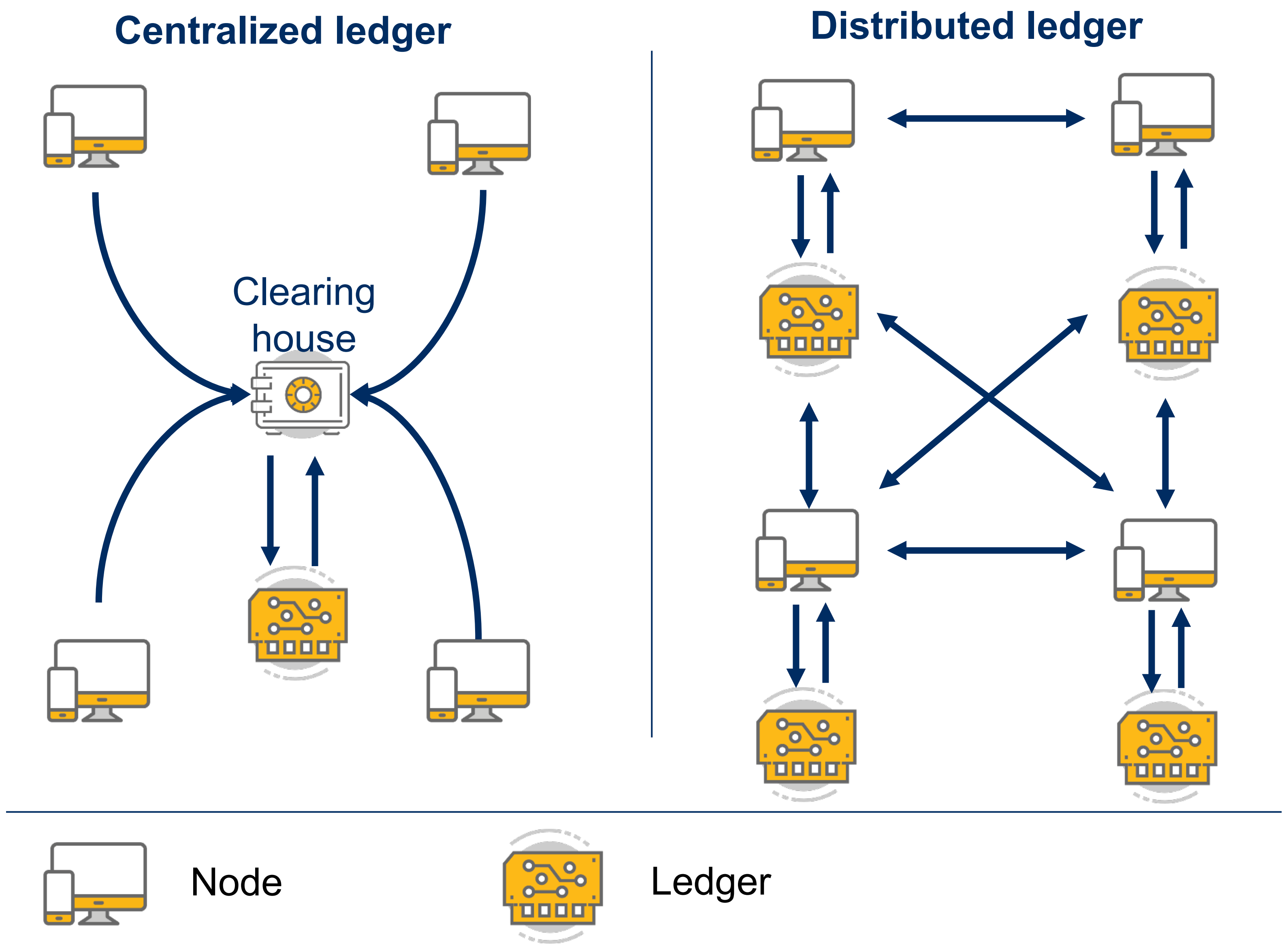
Blockchain technology: A technology that records a list of records, referred to as blocks, that are linked using cryptography. Each block contains a cryptographic hash of the previous block, a timestamp, and transaction data.

Blockchain: A distributed ledger which allows digital assets to be stored, transferred, and transacted in a real-time, immutable manner.

Block: A collection of digital asset transactions recorded on a blockchain.

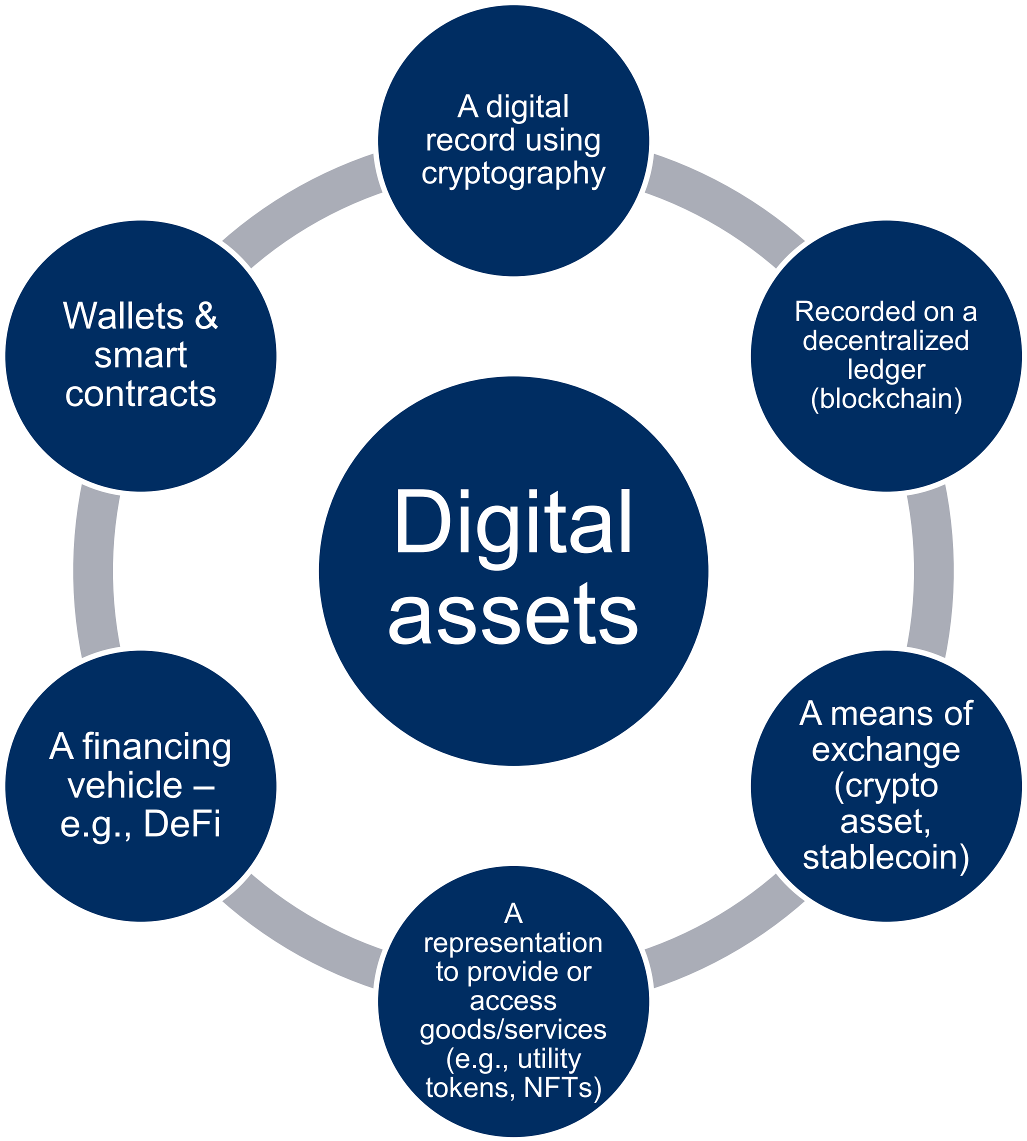
Distributed ledger technology





Digital assets

- Blockchain
- Distributed ledger technology
- Digital assets
- Crypto assets
- Wallets



Crypto assets

- Blockchain
- Distributed ledger technology
- Digital assets
- **Crypto assets**
- Wallets

Function as a medium of exchange

- Bitcoin
- Ether

Characteristics

- Not issued by a jurisdictional authority
- Do not give rise to a contract between the holder and another party
- Are not considered a security under the *Securities Act of 1933* or *Securities Exchange Act of 1934*

Stablecoin?

- Designed to minimize price volatility
- Linking or pegging their value to another asset such as fiat currency, a commodity, or another digital asset

Wallets

- Blockchain
- Distributed ledger technology
- Digital assets
- Crypto assets
- **Wallets**

Digital wallet

- Custodial vs. non-custodial
- Multi-signature
- Hot vs. cold
- Hardware & software

Use cases

Utility tokens

- Reward points
- Access to services
- Wrapped tokens

Industry

- Banking
- Healthcare
- Gaming

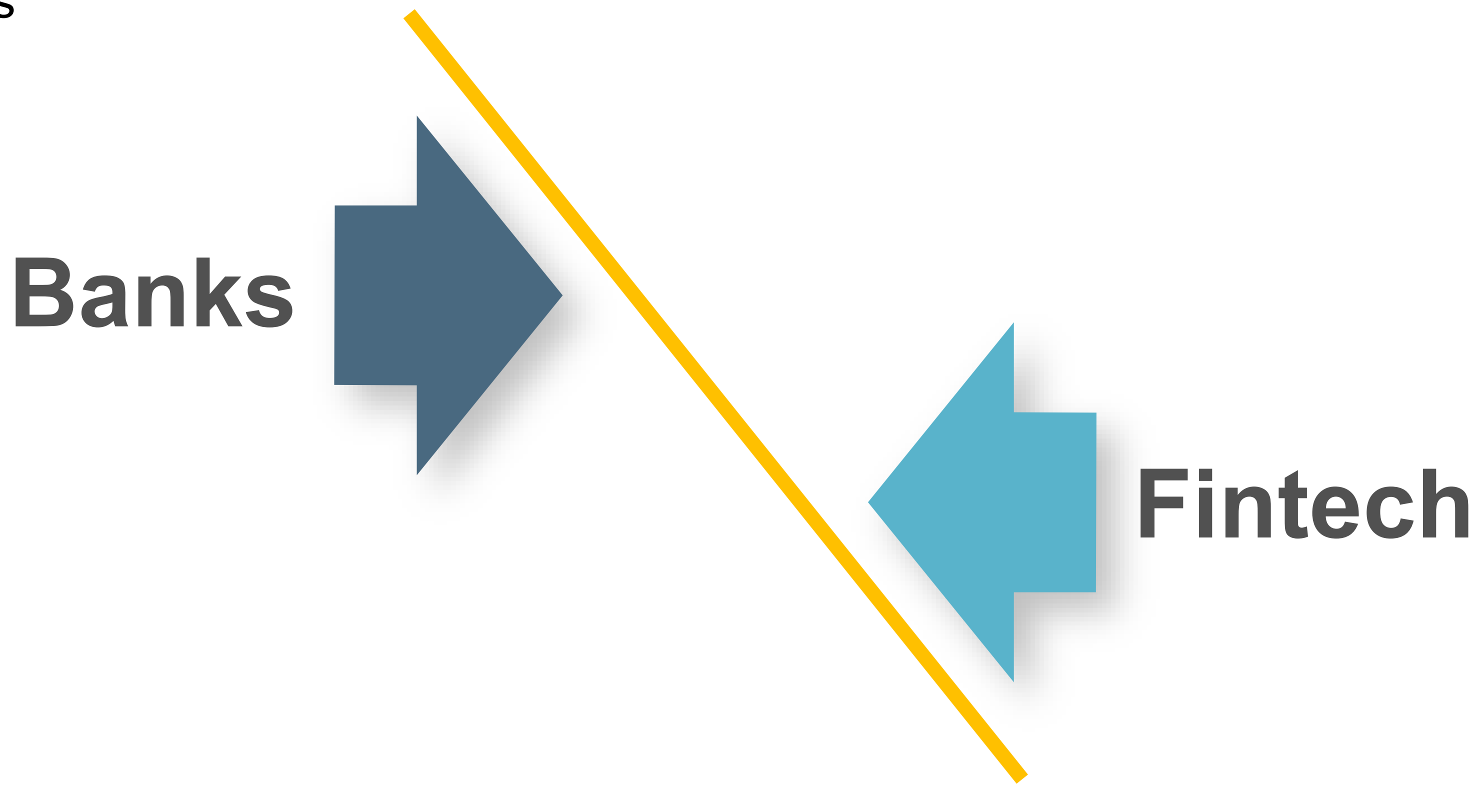
Culture

- Artwork
- Metaverse
- IRL NFTs

Example: Worlds colliding

Banks are engaging with digital assets in different ways through activities such as:

- Banking for digital asset companies
- Payment processing
- Lending against digital assets
- Crypto rewards
- Crypto card programs
- Crypto ATMs
- Custodian of digital assets
- Brokerage and asset management
- Investment vehicle sponsor
- Stablecoins



Understanding the tax treatment

IRS guidance

- March 25, 2014: The IRS released Notice 2014-21.
- Oct. 9, 2019: Rev. Rul. 2019-24 addressed the tax treatment of cryptocurrency forks.
- Oct. 9, 2019: The IRS posted 43 questions and answers (Q&As) on virtual currency on its website, updated to 46 Q&As to date.
- March 22, 2021: The IRS released a Chief Counsel Advice (CCA) that clarifies two confusing points from cryptocurrency guidance issued during 2019.
- June 18, 2021: The IRS released IRS Legal Memorandum (ILM) 202124008 that does not allow a Sec. 1031 exchange on bitcoin, ether, and litecoin that occurred prior to the *Tax Cuts and Jobs Act*.

IRS guidance

- Virtual currency is treated as property (not currency under §988).
- General tax principles applicable to property transactions apply to virtual currency transactions.
- Fair market value (FMV) is used for determining the reportable income from transactions in virtual currency and the basis of virtual currency received.
  - Transactions facilitated by a virtual currency exchange
  - Transactions not facilitated by a virtual currency exchange (index)
  - Transactions without published value

IRS guidance

- Recognition of income and tax gain/loss
  - Sale of virtual currency to real currency (Q&A 4)
  - Virtual currency received for services performed (Q&A 9, 10)
  - Exchange for other property including other virtual currency (Q&A 16)
  - Hard fork (Q&A 22)
  - Airdrops (Q&A 22, 23)
  - Gift (Q&A 31-33)
  - Transfer between wallets (Q&A 38)

IRS guidance

- Determination of basis
  - Cost basis, including fees, commissions and other acquisition costs, expressed in U.S. dollars (Q&A 8).
  - Basis of virtual currency received in exchange for goods or services equals the FMV of virtual currency when received (Q&A 13, 21).
  - Basis of property received in exchange for virtual currency equals the FMV of the property when received (Q&A 18).
  - Basis of cryptocurrency received in a hard fork equals the FMV of cryptocurrency when received (Q&A 25).

IRS guidance

- Basis tracking – specific identification (Q&A 40)
  - Date and time that each unit was acquired
  - Basis and fair market value of each unit at the time it was acquired
  - Date and time each unit was sold, exchanged, or otherwise disposed of
  - FMV of each unit when sold, exchanged, or disposed of, and the amount of money or value of property received for each unit
- If specific identification is not used, units are deemed to be disposed on FIFO basis (Q&A 41)
- Not in Q&As – LIFO, HIFO, average cost basis

IRS guidance

- Capital or ordinary asset
    - Tax character depends on whether the virtual currency is a capital asset under §1221
        - Capital gain or loss on capital assets
        - Ordinary income or loss on ordinary assets
- Holding period (Q&A 6, 29, 33)
    - Short term if virtual currency held one year or less
    - Long term if virtual currency held more than one year
    - Holding period begins on day after you acquire or deem to acquire virtual currency and ends on the day the virtual currency is sold or exchanged

IRS guidance

- Donating virtual currency (Q&A 34-36)
  - Charitable contribution deduction
    - Public charity vs. private foundation
  - Donor acknowledgement responsibilities
- NGOs accepting donation in virtual currency (Q&A 37)
  - Non-cash contributions on Form 990-series
  - Form 8282 if selling, exchanging, or otherwise disposing of charitable deduction property (or any portion thereof) within three years after the date the property was originally received

Top 10 crypto tax compliance tips

1. Keep good records of all transactions related to digital assets (e.g., buy, sell, exchange, receive, earn, or dispose of crypto). If more than a handful of transactions, consider using one of the crypto tax tracking software packages available. The type of records needed to substantiate the positions taken on tax returns includes date, amount, cost basis, holding period, transaction fee, and fair market value (FMV) in U.S. dollars on the date of the transaction.

2. Account for transactions on ALL wallets and exchanges. If the crypto tax tracking software does not support certain wallets, you can always upload a CSV file or manually enter the data.

Top 10 crypto tax compliance tips

3. Wallet-to-wallet transfer between multiple digital wallets you own is not taxable. However, if not all wallets are connected, the crypto tax tracking software could assume that such transfer is a sale and incorrectly generate reportable gain or loss on the transfer.

4. Choose a cost basis method and be consistent. If you decide to change the method, consider whether to file an accounting method change with the IRS or amend prior-year returns to report the proper basis. The IRS allows FIFO (first in first out) and specific identification methods.

Top 10 crypto tax compliance tips

5. Consider the tax consequences of buying an NFT with virtual currency. If you use your virtual currency (such as ETH or SOL) to purchase an NFT, you essentially sold your ETH or SOL which is a taxable event. The purchase price of the NFT less transaction fee is your sale proceeds. Comparing such proceeds to your cost basis, the difference is gain or loss reportable on your tax return.

6. If you founded or collaborated on an NFT project, please work with a tax adviser to understand your tax filing and withholding obligations on the revenue earned at mint and subsequent sales.

7. If you receive compensation in crypto, the income reported on Form W-2 or 1099 is your cost basis in the crypto you received. Note that you will have income even if the payer does not provide you with a Form W-2 or 1099.

Top 10 crypto tax compliance tips

8. If you have significant or material transactions in DeFi protocols such as lending, borrowing, liquidity pool, etc., please work with a tax adviser, as the rules are difficult to understand and implement on your own.

9. If you switch crypto tax tracking software, you could end up with different gains and losses for each year. This is due to a number of reasons, including the source of FMV on crypto-to-crypto transactions. If you are seeing material variances, please work with a tax adviser to evaluate and assess the final output and amend prior year tax returns, if needed.

10. Stay current on the latest IRS guidance, including FAQs, to ensure that transactions in digital assets are accurately reported on your tax returns. https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies

Non-fungible tokens (NFTs)

Nature and characteristics

- Units of data on a blockchain representing full or shared ownership and control of usage rights correlating to an exclusive digital asset, which are generated via smart contracts
- Generally associated with digital property such as artwork, images, video or audio recordings, and text
- Original sales from creators are called “mint”
    - Whitelist/early mint at discount
- Sales and transfers are recorded on blockchain

Non-fungible tokens (NFTs)

Nature and characteristics

- NFTs can potentially include additional features such as, but not limited to:
    - Royalty agreements allowing creator(s) to receive kickbacks on subsequent sales in secondary market
    - Right to physical merchandise
    - Right to future NFTs for free or at discounted price
    - Access to “in real life” (IRL) events
    - Governance rights
    - Other rights and obligations

Non-fungible tokens (NFTs)

Tax considerations

- Creation of NFTs
  - Unlikely to be taxable until sold
  - Likely to be a non-capital asset under IRC Sec. 1221(a)(3): “a patent, invention, model or design … a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by … a taxpayer whose personal efforts created such property.”
- Purchase of NFTs
  - Depends on medium of exchange used to purchase
  - If using virtual currency or other digital asset to purchase an NFT, there could be a taxable event because the purchase using the digital asset is treated as a disposition of such asset, which could generate taxable gain or loss.

Non-fungible tokens (NFTs)

Tax considerations

- Transfer of NFTs
  - Is the transfer considered a sale or license?
  - If sale, amount realized net of tax basis is taxable to the transferor.
    - Sale by NFT creator = ordinary income
    - Sale by NFT dealer = ordinary income
    - Sale by NFT investor = capital gain or loss (could be subject to 28% collectible rate)
  - If license, the license fees and/or royalties are taxable to the licensor as ordinary income

Non-fungible tokens (NFTs)

Tax considerations

- Are NFTs considered collectibles under Section 408?
  - Collectibles are defined in Section 408 as artwork, rugs, antiques, metals or gems, stamps and coins, alcoholic beverages, or other personal property that could be deemed to be collectible.
- Could NFTs be eligible for amortization under Section 197?
  - Section 197(c)(2) generally precludes self-created assets from being amortized.
- Could NFTs be considered Section 1231 property used in a trade or business?
- How are sale proceeds on NFTs sourced for state tax purposes?

Questions?

Resources

- Crowe resource page for digital assets
- "The Cryptopians" by Laura Shin
- "Unchained" podcast with Laura Shin
- "Attack of the 50 Foot Blockchain" by David Gerard
- "Web3 is going just great" (blog) –Molly White

Thank you

Trudie Kanter, CPA
Partner
+1 630 586 5126
trudie.kanter@crowe.com