PROGRAM MATERIALS
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Filing Taxes on Crypto Gains/Losses

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Cryptocurrency Gains & Losses – What Your Clients Need to Know

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5 Questions for Today

1. What do we mean by cryptocurrency?
2. How are cryptocurrencies regulated and which US agencies claim regulatory oversight?
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Fundamentals

Blockchain

1. Linked data between computers → enables transactions that are <u>faster</u> and <u>more secure</u>

And *no need for intermediary*

2. Any entity can establish its own blockchain

Fundamentals

3. Some **blockchains are used to distribute and track <u>currencies</u>**

4. <u>Cryptocurrency</u>

digital currency exchanged on a blockchain

Fundamentals

5. 2,071 crytocurrencies exist

Combined value?

Cryptocurrencies: 2071 • Markets: 16009 • Market Cap: $132,415,418,192 • 24h Vol: $33,072,268,571 • BTC Dominance: 52.1%

CoinMarketCap

Rankings Trending Tools Services

Top 100 Cryptocurrencies by Market Capitalization

Cryptocurrencies Exchanges Watchlist USD

#	Name	Market Cap	Price	Volume (24h)	Circulating Supply	Change (24h)
1	Bitcoin	$68,998,224,695	$3,932.01	$9,678,303,356	17,547,825 BTC	-0.01%
2	Ethereum	$15,053,090,535	$143.46	$5,237,111,750	104,928,541 ETH	-2.76%
3	XRP	$13,289,574,899	$0.321711	$1,129,217,473	41,308,998,845 XRP *	-0.64%
4	EOS	$3,206,515,923	$3.54	$1,868,891,231	906,245,118 EOS *	-2.41%

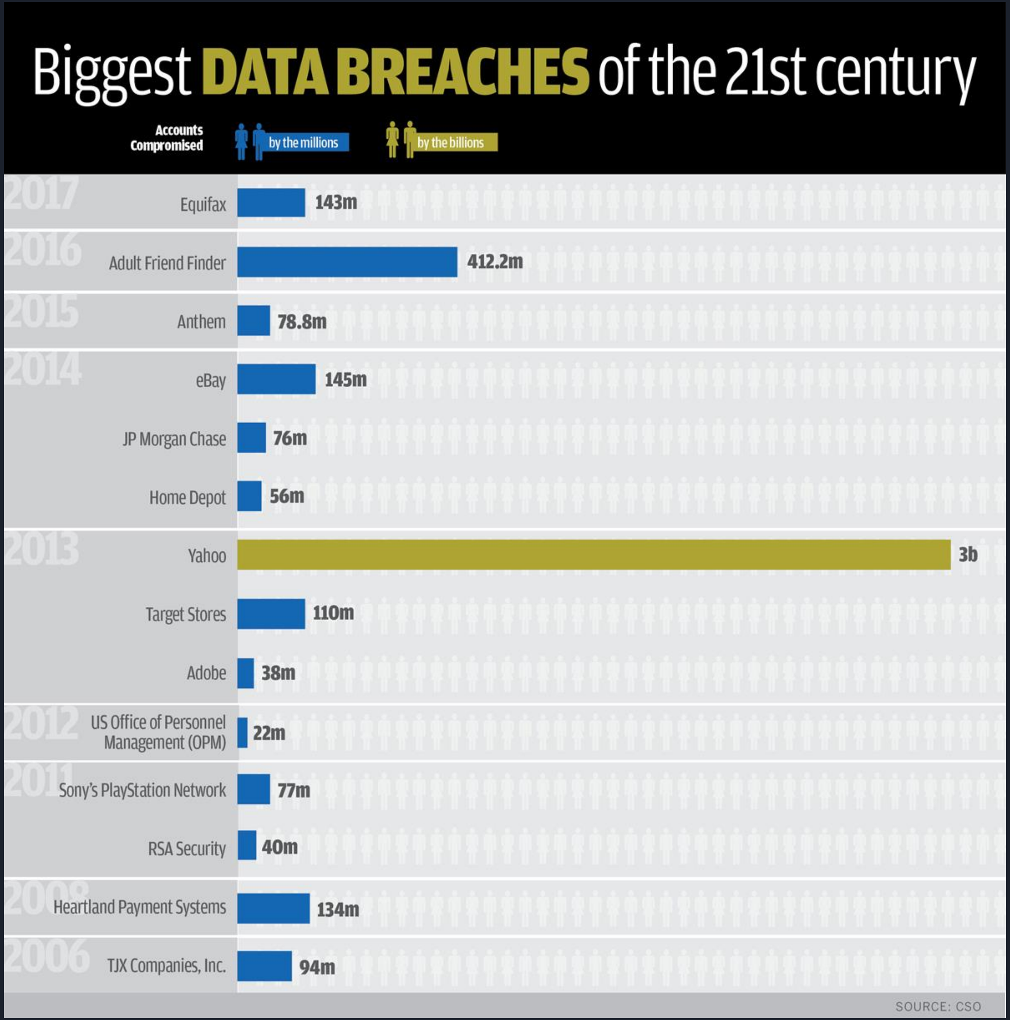
What problem do blockchains solve?

Challenges with tracking transactions?

- Hard to remember → populate a database

- Problems with a database?
  - Cumbersome to track large quantities of data
  - Who’s version is most correct?

- Potential for dishonesty → bank or trusted party
  - Expensive intermediaries
  - Trust that bank or institution won’t get hacked
  - Trust that admin access won’t be abused
  - Delays


Biggest DATA BREACHES of the 21st century
Accounts Compromised
by the millions
by the billions
2017
Equifax
143m
2016
Adult Friend Finder
412.2m
2015
Anthem
78.8m
2014
eBay
145m
JP Morgan Chase
76m
Home Depot
56m
2013
Yahoo
3b
Target Stores
110m
Adobe
38m
2012
US Office of Personnel Management (OPM)
22m
2011
Sony's PlayStation Network
77m
RSA Security
40m
2008
Heartland Payment Systems
134m
2006
TJX Companies, Inc.
94m
SOURCE: CSO

Blockchain Explained: a definition

Blockchain: Globally distributed, append-only ledger that allows nearly instantaneous transfer of any digital asset in a trustless fashion.

Blockchain Explained

Digital Assets

- Code
- Text/copy
- Photo/video
- Databases
- Contracts
- Land title
- Wills
- Copyrights
- Software

Legal Issues & Blockchain

- Smart Contracts
- Shipping/Logistics
- Identity security
- Digital copyrights
- Title Records
- Escrow
- Debt
- Crowdfunding

Cryptocurrencies

- Current movement of money
  - Fastest method: ?
  - Second-fastest: Western Union/Moneygram
  - Third-fastest: Domestic/International wires between banks

- Problems with this model?
  - Expensive
  - Slow
  - Uncertain - is the wire going through?
  - Requires trust of sending institution

Purpose of Cryptocurrencies

Move money around the world

In an instantaneously verifiable way

For little to no fee

Without a need to trust any intermediary

Cryptocurrencies

Method of moving $	Speed
International Wire Transfer	10 – 14 days
Western Union wire	12 - 24 hours
Paypal	193 trxns/sec
Ripple	1500 trxns/sec

Cryptocurrencies

Who would actually use a made-up currency?

- Carnival tickets
- Laundromat tokens
- Target card
- Airline miles
- Amazon Prime “Reload” gives 2% discount (Amazon-only balance)

Cryptocurrencies

But what could you do with a company-specific currency?

World Bond Market	$85,000 Billion
US Stock Market	$67,000 Billion
Total Value of Gold	$8,200 Billion
US Dollars in Circulation	$1,600 Billion
Apple, Inc	$911 Billion
Berkshire Hathaway	$483 Billion
All Cryptocurrencies	$455 Billion
Bitcoin	$158 Billion

2018

- 1,833 currencies
- $16B traded daily

Cryptocurrencies

Big Picture

Moving money around the globe is <u>one</u> of many use case for blockchain technology

<u>Value Proposition</u>: Move money across borders in an instantaneously verifiable way, without trusting or paying an intermediary to hold your money (may also be anonymous)

Tracking Cryptocurrencies on Exchanges

- Buy & sell cryptocurrencies on exchanges
- Directly transact with friends/family, as with Venmo

- Most secure: Coinbase
- Highest volume: Binance
- Tied to traditional investments: Gemini
- Cheapest (free): Robinhood

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Cryptocurrency: Subject to Regulations?

- Securities & Exchange Commission (SEC)
- Commodity Futures Tradiging Commission (CFTC)
- Internal Revenue Service (IRS)

- What’s missing?
  - One definitive regulatory framework

Cryptocurrency: Subject to Regulations?

- **Securities & Exchange Commission (SEC)**
  - Decides whether or not to define tokens and coins as securities
    - Determination?
      - *Howey* test: it is a security IF
        - investment of money
        - in a common enterprise
        - in which the investor expects profits primarily from others' efforts.

Cryptocurrency: Subject to Regulations?

- **Commodity Futures Trading Commission (CFTC)**
  - May 2018: provided guidance for listing virtual currency derivative products
    - necessity for more market surveillance
    - coordination with CFTC staff
    - large trader reporting

Cryptocurrency: Subject to Regulations?

- **Commodity Futures Trading Commission (CFTC)**
  - Guiding philosophy:
    - [“Do] no harm” was unquestionably the right approach to development of the Internet. Similarly, I believe that “do no harm” is the right overarching approach for distributed ledger technology. “

- Chairman J. Christopher Giancarlo

Cryptocurrency: Subject to Regulations?

- **Internal Revenue Service (IRS)**
  - Are crypto assets taxable?
  - What's considered a taxable event?
  - Notice 2014-21 governs
    - Treats as property, rather than currency

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Cryptocurrency: (Frequent) Taxable Events

MOST IMPORTANT TAKEAWAY = *Taxable Event* includes

- Trading crypto
- Buying crypto with crypto
- Selling crypto for Fiat (i.e., USD)
- Buying items or paying for services rendered with crypto

IRS Notice 2014-21 (March 25, 2014)

Guidance in the form of FAQs

- Translate existing principles to “convertible virtual currencies”

1. Virtual currency is treated as property
2. Virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes
3. Gross income calcs: must include the FMV of the currency in USD on the date the currency was received
4. The basis is the FMV
5. FMV = convert to USD at market rate, “in a reasonable manner that is consistently applied”

IRS Notice 2014-21

6. Gain or loss if the FMV of property received is more or less than the taxpayer's adjusted basis of the virtual currency
7. Sale or exchange of currency: generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer.
    a. CAPITAL - stocks, bonds, and other investment property
        i. SHORT TERM: ordinary tax rate (up to 37%)
        ii. LONG TERM: up to 20%
    b. NON- CAPITAL - Inventory and other property held mainly for sale to customers in trade

IRS Notice 2014-21

MINING

8. FMV as of the date of receipt
9. If mining constitutes a trade or business, the net-earnings are subject to self-employment tax

IRS Notice 2014-21

10. Currency received for services performed as an independent contractor is self-employment income
11. Currency received as wages is similarly taxed at FMV, reported on W2
12. Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property (get a TIN from the payee)
13. Penalties for: underpayments, inaccuracies, non-timely reporting

Comments Sought from the Public

- IRS seeks comments regarding other types or aspects of virtual currency transactions that should be addressed in future guidance.
  - Submit comments electronically via e-mail to the following address: Notice.Comments@irscounsel.treas.gov
  - Taxpayers should include “Notice 2014-21” in the subject line.

What About Like-Kind Exchanges?

- **<u>Prior to 2017</u>**
- It's possible for cryptocurrency to qualify as "like-kind property"
- The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character." *Koch v. Commissioner*, 71 T.C. 54, 65 (1978)
  - "nature or character" standard is a highly factual and nuanced test
  - taking a position on their tax return that lacks sufficient legal authority can subject them to civil penalties
- Even if tax-free, <u>must still be reported</u> using Form 8824
- The IRS may reject like-kind exchange treatment for crypto-to-crypto trades
- You may end up owing additional taxes, interest, and penalties
- The IRS could choose to assess an accuracy related penalty for negligence or "substantial
- understatement of tax." (20% of the additional tax assessed)
- The IRS might have six years to reject your use of Section 1031, if omitted more than 25%
  of their income

What About Like-Kind Exchanges?

- **<u>Jan 1, 2018 and beyond</u>**
- Section 1031 was amended to make like-kind exchanges only applicable to real estate transactions (Tax Cuts and Jobs Act of 2017)

- Crypto-to-crypto trades are permanently foreclosed from like-treatment

Loss, Theft or Fraud

- Prior to 2018:
- stolen property could be claimed as a deduction by reporting it as a casualty loss

- After 2018:
- deduction for stolen crypto has been removed and now is only available for presidential declared disasters

- FRAUD: could be a capital loss

Itemized Deductions?

- *miscellaneous itemized deductions* - only deductible to the extent they exceed 2% of AGI
  - Doesn’t include: commissions and wire transfer fees
    - (part of "amount realized" and "basis”

POTENTIALLY:

- Interest paid on funds that you borrowed in order to invest (limited to the amount of your net gains)
- Rent expense for a safety deposit box (arguably the cost USB drives for cold storage)
- Consulting fees for the tax treatment of holdings
- Depreciation on equipment used in the production of income, such as your computer (must allocate the cost between personal use and investment use)

Does It Matter…?

- If the transaction doesn't involve USD?
  - No.
  - Irrelevant whether fiat currency was involved. Every single cryptocurrency transaction must be tracked and reported.
  - Your gains were realized the moment you sold them
- If the taxpayer never put the crypto in their own wallet?
  - No.
  - If the taxpayer had access to the funds on an exchange or other forum of trade, it's taxable

Does It Matter...?

- If the exchange is based outside the US
  - No.
  - All activity by US residents is subject to taxation.

- If I received it via airdrop or fork?
  - No.
  - All crypto is treated as income, with a USD based FMV on the day it was received.

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REPORTING REQUIREMENTS

- **Who Has Reported?**

- IRS calculated that less than 900 taxpayers reported capital gain or losses on crypto transactions in 2015
- IRS demanded that Coinbase provide detailed personal information for more than a million customer accounts
    - IRS subsequently limited its demand to ask only for accounts that conducted crypto transactions worth $20,000 or more

REPORTING REQUIREMENTS

- **Who Must Report?**

- Tax-payer
- No third-party duty to report virtual currency (yet)
- No 1099B or equivalent issued
- Some exchanges offer a summary of transactions
- But once you leave that exchange, it becomes very hard to track

REPORTING REQUIREMENTS

- **Who (Else) Might Report?**

- Exchanges
  - 2017 case required Coinbase to report accounts that bought, sold, sent or received over $20,000 in a year from 2013-2015

- ”Payment settlors" who convert bitcoin payments to cash for merchants will have to file 1099s

REPORTING REQUIREMENTS

- **Who (Else) Might Report?**

- Bank or crypto exchange might file a Suspicious Activity Report ("SAR").
  - Require SARs for wire transfers that are “suspicious” and larger than $5,000
  - ($2,000 in the case of crypto exchanges)
  - they are prohibited from telling you if they did

- Others, out of jealousy and for the reward

REPORTING REQUIREMENTS

- **Best Practices in Crypto Record-keeping**

- Keep every record.
- Create a log of every transaction
- Download CSV files of your trading history frequently (quarterly).
- Export transaction logs from wallets

REPORTING REQUIREMENTS

- **How Important Are Records?**

- Recognize that exchanges go OOB, offline and disappear often
- Burden is on the taxpayer
  - You are required by law to maintain records
  - Failing to do so will result in civil penalties
    - if you are subsequently audited and owe additional tax.
- Long-term capital gains:
  - might be required to prove the long-term gains you declared were owned for more than a year

REPORTING REQUIREMENTS

- **Treat Sales/Exchanges like other capital assets**

- Schedule D of Form 1040: Net short-term and long-term capital gains.
- Form 8949: The individual transactions themselves are reported on.
  - If there is a high volume of transactions, they can be reported on a separate statement and attached to Form 8949

REPORTING REQUIREMENTS

- **Swiss and Cayman Island Accounts are Exempt, Right?**

- Wrong.
- Must report financial accounts held at foreign financial institutions
  - *The Bank Secrecy Act*
    - if the total aggregate value of all your foreign accounts exceeds $10,000 at any point
    - If so, file an FBAR form
  - *The Foreign Account Tax Compliance Act*
    - If the total aggregate value of all your foreign accounts is over $75,000 during the year or over $50,000 on Dec 31

REPORTING REQUIREMENTS

- **Foreign Account Reporting**

- Do crypto wallets and crypto exchanges fall within the definitions of the terms of these Acts?
  - Unclear. Do you want to be the test-case?

- Do the reporting requirements apply to crypto kept in paper wallets?
  - Probably not a "financial account" held at "foreign financial institution", but not yet clear.
  - Fair to assume that any business accepting deposits on behalf of customers is a "financial institution"

REPORTING REQUIREMENTS

- **Consequences for Failing to Report?**

- Significant IRS penalties
- Possibility of criminal prosecution
- Civil action initiation by the IRS
  - no time limit for an audit
    - if you are charged with civil fraud *OR*
    - never filed your tax returns
- Penalties for failing to report foreign financial accounts
  - If **willful**, the penalty is the greater of $100,000 or 50% of the highest account balance for each account

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Available Tools for Tracking / Reporting Crypto

BitcoinTaxes

- Easy to use
- Less expensive
- Simply for generating tax statements
- 21 exchanges + import
- $30/yr and up

CoinTracking

- More advanced options
- Tracks coin history, movement, and gains/losses in real time
- Tax statements
- 40 exchanges + import
- Free (limited), $91 and $146/yr

bitcoin.tax/faq ← Super helpful FAQs

Emerging Use Case #1

Ethereum blockchain (coin = ETH)

- A blockchain welcoming to smart contracts
- Executes software of decentralized apps (dApps)

Example: Automate property transfers or payments of dividends

What’s a Smart Contract?

An Example

- I rent an apt from you through a blockchain (keyless entry)
  - I pay cryptocurrency into escrow
  - Our virtual contract is viewable on our blockchain
  - On the lease start date, the contract sends me a digital entry code
  - If you don’t send key on time, I get refunded automatically
  - If you *do* send key on time, you get paid rent automatically
  - Lease is automatically cancelled, unless we code it otherwise

Witnessed by hundreds of people

Code cannot be interfered with

All participants see all transactions and changes to terms

Emerging Use Case #2

Foodborne illness

- After E. Coli in late 2015, Chipotle profits dove 44% over 2014
- Every year, 1 in 10 people become ill due to foodborne diseases, and approximately 420,000 of them die
- What if we could track where every food item originated, inexpensively?

Emerging Use Case #2

Foodborne illness

- Oct 2016: Walmart teamed up with IBM and Tsinghua University in Beijing to digitally track the movement of pork in China on the blockchain

- Feb 2018: Recent testing by Walmart showed that applying blockchain reduced the time it took to trace a package of mangoes from the farm to the store from days or weeks to two seconds.

SOLUTION

Shipping/Logistics

- IBM and Maersk joining up to create a blockchain-enabled global shipping platform
- provides a real-time, transparent view of merchandise movement and smart contracts
- 80% of shipping is across oceans ($4T industry)
- DuPont, Dow Chemical and US CBP experimenting

Emerging Use Case #3

Advertising

- I’ve paid for an ad online.
- Is my customer seeing it?
  - What if one could track how much time their eyes spent on a section of page?
- BRAVE Browser: a new attention-based ecosystem of rewards

Emerging Use Case #4

Voting

When elections are contested, how do we get precise - both quickly and accurately?

How do we get more people out to vote? (only 55.7% of voting-age pop voted in 2016)

How could we keep a digital election from being hacked?

Emerging Use Case #4

Voting

Sierra Leone [now using](#) to count votes in densely populated centers

Not the official vote, but an independent count for comparison purposes

Agora built the blockchain

Voting on the Blockchain

Limited group in WV could vote in recent primary using mobile blockchain app

Blockchain Use 4

Voting

One of the largest banks in Europe, used blockchain technology for investor voting in May 2018.

Emerging Use Case #5

Birth Certificates

- Illinois using blockchain to store birth certificates
- Accessed in seconds
- Share with third parties
- “Businesses and governments will be able to verify and authenticate citizens by requesting encrypted access to these verifiable claims. This minimizes the need for entities to establish, maintain and rely upon their own proprietary databases of identity information.”

Emerging Use Case #6

Power Ledger (coin = POWR)

- Disrupt utility companies
- Enable customers with solar panels to sell power to neighbors
- Get paid in POWR tokens
- Incentivize market participation

Emerging Use Case #7

Collectibles

- On November 28, 2017, Launch Labs launched CryptoKitties
- ***Within a month***, approximately 180,000 individuals signed up for the game
- Brought in $20 million in revenue

Blockchain Use Case #8

Banking the Unbanked

- Unbanked consumers in the US: 15.6 MM
- Unbanked people in the world: 2B
- India: 21%
- China: 12%

World Bank: costs, regulations, paperwork, travel, legal hurdles

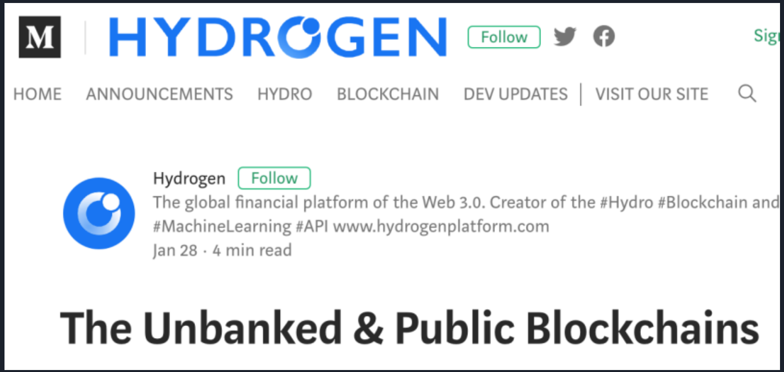
How does a Syrian refugee in Philly begin banking and saving?

Blockchain Use Case #8

Banking the Unbanked

What if a bank stored fingerprints immutably and securely on a blockchain?

Might a fingerprint be enough to establish ID?



Emerging Use Case #9

Smart Contracts

- Self-executing (coded) contracts
- Execute or enforced once an **if/then** trigger is reached
- Sequential and contingent contracts form the basis of full automation
- Need to be:
  - Specific
  - Secure
  - Transparent
  - Eliminate human error

Emerging Use Case #10

Legal Services

- **Legaler** Plans Launch of Legal-Industry Cryptocurrency and Blockchain-Based Legal Charity
  - Secure online video-chat for lawyers/clients
  - Will accept cryptocurrencies

- **Legaler Aid**: crowdfund cases to provide indigent representation

Appellate Courts

NEW YORK

- Trademark infringement
- False advertising
- False and fraudulent representations in ICOs
- Application of the *Howey* test and use of investment contracts [*United States v. Zaslavskiy*, 2018 WL 4346339 (E.D.N.Y. Sept. 11, 2018)]
- SEC sued a FinTech company for selling unregistered securities [*Sec. & Exch. Comm'n v. Longfin Corp.*, 316 F. Supp. 3d 743 (S.D.N.Y. 2018)]

Appellate Courts

NEW YORK

- CFTC sued a pooled-investment company that purported to sell option-contracts and investments with promised returns to investors and entrepreneurs [*CFTC, V. Dillon Michael Dean & The Entrepreneurs Headquarters Limited*, 2018 WL 4573029, at *1 (E.D.N.Y. July 9, 2018)]

CALIFORNIA

- Misappropriation of Trade secrets

PENNSYLVANIA

- Jurisdictional tests

Ask me questions offline!

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