Crypto & Your Taxes

Cryptocurrency went from being largely unregulated and untaxed to being one of the most closely watched taxable activities practically overnight. A little checkbox showed up near the top of 2020's Form 1040, asking a yes-or-no question about it. You may have overlooked it a year ago but have dipped your toe in the cryptocurrency pool since. Maybe you personally invested in it or exchanged (gave or received) it for business purposes.

The virtual currency the IRS is asking about includes "various types of convertible virtual currency...used as a medium of exchange, such as digital currency and cryptocurrency." You're likely already familiar with the names of the leading cryptocurrencies and exchanges: Bitcoin, Ethereum, and exchanges like Coinbase, Gemini, and now even PayPal. The IRS keeps their definition broad for obvious reasons: To ensure that whatever types of virtual currencies come and go, "regardless of the label applied, if a particular asset has the characteristics of virtual currency, it will be treated as virtual currency for federal income tax purposes."

If you're new to cryptocurrency, you may have missed the announcement in 2014 that the IRS would start treating crypto as property, not money. Since then, transfers and trades of crypto (even for other virtual currencies) require reporting and can trigger more taxes. As property, virtual currency exchanges are subject to capital gain and loss rules, including short- and long-term tax rates. If you hold the asset for longer than a year, it will be taxed as a long-term capital investment. However, if you hold the asset for less than one year before selling or exchanging it, you will pay higher ordinary income rates.

If you simply bought and held crypto last year, you likely won't owe taxes. But the IRS doesn't want you to figure out whether you owe taxes or not before you disclose your crypto activity. That little question on Form 1040 wants to know if, at any time during the tax year, "did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?" Dodging or answering the question in a way that the IRS can dispute can have severe consequences, including interest, penalties, or the criminal charges of tax evasion or fraud.

It's essential to disclose all crypto activity to your CPA so that the box can be checked correctly and appropriate tax treatment can be assigned. It may not be surprising to learn that tax rules on virtual currencies are about to get more complex beginning in 2023, particularly when it comes to reporting and valuation. That's even more reason to be sure your reporting is on par from the start.

Steven Bankler has more than 45 years of experience in the accounting industry. Steven's expertise lies in consulting, planning, tax, and asset protection as well as exit strategy services for closely-held businesses. He also provides litigation support (both as a testifying expert witness and a consulting expert), business negotiations, and estate planning. Visit www.bankler.com for additional tax strategy tips and to learn more about Steven Bankler, CPA, Ltd.