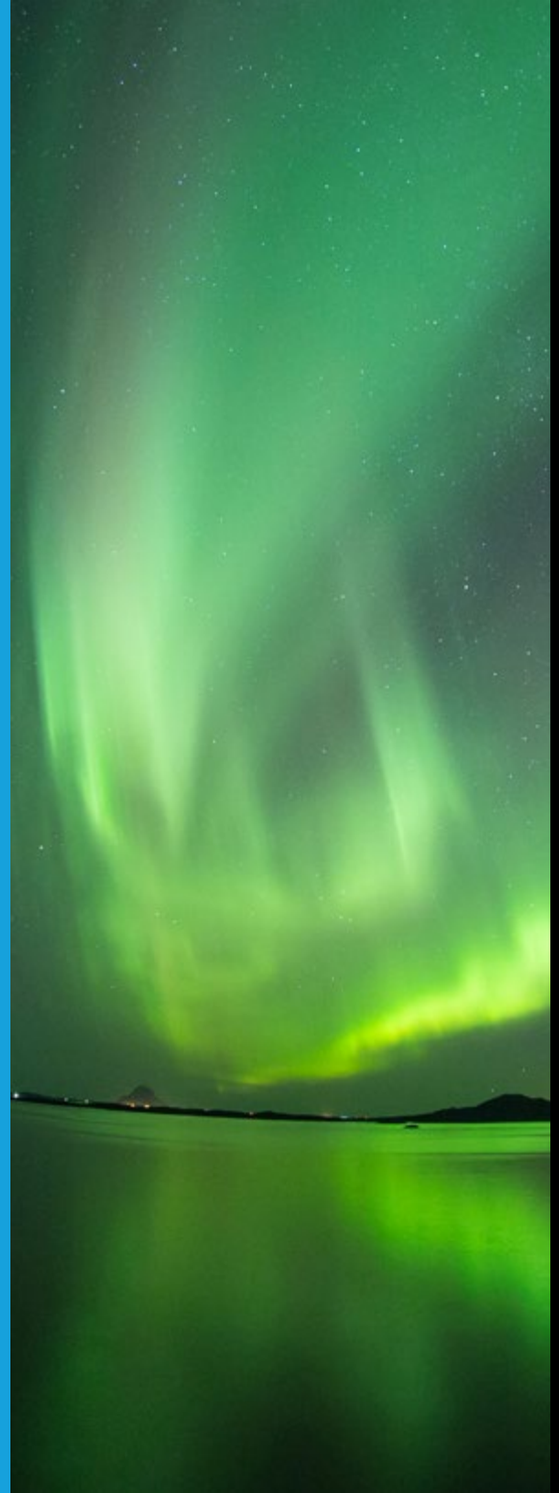
Cryptocurrencies

Cryptocurrencies are virtual currencies that use encryption techniques to regulate the generation of units of currency and verify the transfer of funds. Cryptocurrencies operate independently of a central bank or similar institution; instead, they employ a decentralized ledger system built on blockchain technology. In other words, network participants self-regulate on a peer-to-peer basis rather than rely on a trusted third party.



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What are cryptocurrencies?

An entity creates a cryptocurrency by solving complex cryptographic algorithms (e.g., SHA-256) to arrive at the representation of one unit of value, such as a coin or token.

Cryptocurrency coins and tokens have come into their own as an asset class and are becoming an increasingly popular topic in wealth planning discussions. A person may take possession of cryptocurrency through a variety of means, including purchasing them through an exchange; indirectly, by investing in a private equity fund; and receiving them as compensation for employment, to name a few examples. A person may also be a participant in a cryptocurrency network as a miner, solving computations and supporting the network in exchange for the reward of additional cryptocurrency.

Income tax considerations

Presently, there is a dearth of formal guidance from US government regulators. The only guidance from the Internal Revenue Service (IRS) to date is IRS Notice 2014-21, whereby the IRS has stated that virtual currency is treated as property for federal tax purposes. The guidance, while helpful, addresses a very limited number of issues. What many cryptocurrency holders and their advisers are discovering is that the tax treatment of transactions involving cryptocurrency is much more complex than the tax treatment of more traditional assets such as stock and securities.

The federal government has yet to inform the public which agency or agencies will regulate cryptocurrencies and when it will issue regulations that will provide the information needed to report cryptocurrency transactions. As a result, cryptocurrency exchanges are only slowly starting to provide tax documents like 1099-K forms to traders, and the accuracy of these documents is open to debate.

For the unwary taxpayer, a number of pitfalls may exist. One common mistake is the belief that exchanging cryptocurrency for cryptocurrency is not taxable until ultimately converted to fiat (e.g., USD). The exchange of cryptocurrency for anything (e.g., other cryptocurrency, property, or services) is a recognition event for tax purposes. This oversight can cumulatively result in a significant and sometimes unidentified tax liability to the extent of gain on those transactions, particularly for active cryptocurrency traders. Another problematic area is the misapplication of section 1031 like-kind exchanges to cryptocurrency. Cryptocurrency in almost all cases does not qualify as property for like-kind exchanges under the section 1031 framework, and assertions to the contrary—both now and in prior years—could result in tax positions that are costly and onerous to unwind.

Note that in IR-2018-71, the IRS reminds taxpayers that income from virtual currency transactions is reportable on their income tax returns. Further, the IRS recently indicated that it is concerned about the failure to report capital gains related to cryptocurrencies and some business use of cryptocurrency to pay employees and to buy and sell goods.

It is important to think through these and many other issues when investing in cryptocurrencies. Getting the appropriate tax advice is essential to avoid pitfalls and stay compliant with your tax obligations.

- How should you track your basis?
- How should you treat the chain split coins and air-dropped tokens?
- Do you need to file an FBAR if you trade on a foreign exchange?
- What happens if you donate cryptocurrencies to charities?
- How are cryptocurrency loans taxed?
- What kind of investment vehicles should you use?
- Do wash-sale rules apply?
- What happens if you lose your key or access to your wallet?

Estate and gift tax considerations

With the increasing amount of wealth generated from cryptocurrencies, estate and gift tax planning involving cryptocurrencies has become a hot topic.

Due to the high volatility of cryptocurrencies, planning techniques like simple transfers to irrevocable grantor trusts may not be appropriate. On the other hand, a grantor-retained annuity trust, or a charitable remainder trust (especially for young players in the cryptocurrency world who do not yet have heirs), may be more attractive.

There are many considerations when it comes to estate and gift tax planning involving cryptocurrencies. Advisers should consider estate and gift tax planning in conjunction with income tax planning tailored for each individual's or family's situation.