

## Virtual Currency and Virtual Transactions – Real Tax Issues in Real Dollars

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By Scott K. Tippet



Recently the IRS released a draft form of Form 1040 for the upcoming tax year. The biggest change is a more detailed question about virtual currency transactions. The new draft form asks, “At any time during 2022, did you: (a) receive (as a reward, award, or compensation); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset),” followed by a “Yes” or “No” box. You can see a copy of the draft form [here](#). Although not as bad as some expected (Line A-How much did you make last year? Line B-How much do you have left? Line C-Send Line B.), this change shows the Service is increasing its scrutiny of virtual currency transactions and, not coincidentally, subjecting taxpayers to false statement penalties if they are not truthful in their answer.

Although the question asking about virtual currency did not appear on the 1040 until 2020, as seen [here](#), the Service began issuing guidance on virtual currency and transactions as early as 2014, as seen in [Notice 2014-21](#). Five years later, in [Rev. Rul. 2019-24](#), the Service issued further guidance to address “hard forks” and “airdrops.” So, what are the rules?

First, despite the moniker, virtual currency or cryptocurrency, the Service considers virtual currency (Bitcoin, Dogecoin, Ethereum, as well as all other cryptocurrencies) to be personal property, not currency. Setting aside currency arbitrage transactions, the basis of currency is the face value of the currency. If I receive a \$100.00 bill, my basis in that Benjamin is always \$100.00 (I can’t depreciate it), and when I dispose of it (use it to buy, say \$100.00 of Dogecoin), I have no gain or loss on the disposition of that bill.

Now, because Dogecoin is treated as property and not currency if my \$100.00 of Dogecoin grows to \$300.00 and I use it to buy something else for \$300.00, I have taxable gain, in this case, \$200.00. Because my Dogecoin is considered property, not currency, the gain will be taxed either as ordinary income or as a capital gain. Whether the gain is taxed as a capital gain depends on whether the Dogecoin is a capital asset in my hands. *See Q & A No. 7, Notice 2014-21*. If I do not hold the Dogecoin in inventory for sale to others but hold it as an investment, much like stocks, bonds, and other investments, it should be treated as a capital asset and taxed at capital gains rates. If I satisfy the long-term capital holding period (more than one year, i.e., a year **and** a day), then I get the favorable long-term capital gain rates, which generally are lower than short-term capital gain rates.

Let’s take the flip side. What if someone **pays me** in virtual currency? What is my basis in the virtual currency with which I was paid? My basis is the fair market value of the virtual currency on the date of receipt. *See Q & A No. 4, Notice 2014-21*. Transactions using virtual currency must be reported in U.S. dollars for U.S. tax purposes. If the virtual currency is traded on an exchange, the value can be determined simply by looking at the exchange rate on the date of receipt or payment. Where the virtual currency is not traded on an exchange, the taxpayer still must determine the fair market value based on all the facts and circumstances.

What if I receive virtual currency in payment for services? If I am an independent contractor (I receive a 1099), the receipt of virtual currency is considered self-employment income, which means it is subject to self-employment tax. This also means that payment to an independent contractor using a virtual currency is subject to information reporting, i.e., reporting to the IRS payments of \$600 or more in the same tax year to the same person, and the attendant penalties for not filing information returns.

If I am an employee (I receive a W-2 from my employer), the payment of wages in virtual currency is subject to federal income tax withholding and, if I am the employer, to the employer's share of employment taxes. If I am an employer, I must pay the taxes withheld and the employer's share of employment taxes in U.S. currency, not Dogecoin or any other virtual currency.

What if I "mine" virtual currency? If I mine virtual currency, the fair market value of the virtual currency as of the date of my receipt of it is included in gross income. What if I "mine" virtual currency as a trade or business? If I mine virtual currency for my own trade or business or as an independent contractor, the net earnings from that activity constitute self-employment income, but I am entitled to deduct my ordinary and necessary business expenses in determining my net income.

You said something about hard forks and airdrops; tell me more. (For those unfamiliar with soft forks and hard forks, click [here](#) to read an *Investopedia* article containing a brief explanation). Typically, and grossly general terms, a hard fork results in the creation of a new cryptocurrency. After a hard fork, transactions involving the new cryptocurrency are recorded on a new distributed ledger, while transactions involving the old or legacy virtual currency continue to be recorded on the old legacy ledger.

An airdrop is a way of distributing units of virtual currency to the distributed ledger addresses of multiple taxpayers. Hard forks are often, but not always, followed by airdrops. Generally, a virtual currency is received from an airdrop on and at the date and time it is recorded on the distributed ledger.

For U.S. tax purposes, whether the taxpayer received the virtual currency on and at that date and time is determined by the dominion and control test. If the taxpayer has dominion and control over the virtual currency on the date and at the time it was airdropped, then the taxpayer, if on the cash basis of accounting, has gross income under IRC § 61(a)(3) on and at the date and time of receipt.

On the other hand, if the hard-forked virtual currency is airdropped into a wallet managed by an exchange that does not support the newly created (hard forked) virtual currency, which means the taxpayer cannot transfer, sell, exchange, or otherwise dispose of it, then the taxpayer does not have dominion and control over the new hard fork airdropped virtual currency, and it would not be included in the taxpayer's gross income unless and until the taxpayer later acquired dominion and control over it.

The use of virtual currencies and transactions using virtual currencies can create real tax issues. If these tax issues result in federal tax liability, those liabilities must be paid with the U.S., not virtual, currency. If in doubt regarding the tax consequences of buying, selling, using, or mining virtual currency, taxpayers should consult their tax advisor regarding the implications of buying, selling, and using virtual currencies.

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