CRYPTOCURRENCIES HAVE GONE MAINSTREAM

For example, you can use bitcoin to buy far more than you would think. To see, try googling "What can I buy with bitcoin?" You will get more than 350,000 hits.

But using cryptocurrencies has federal income tax implications that may surprise you.

With the price of bitcoin having gone through the roof (before its recent decline), and with increasing acceptance of bitcoin and other cryptocurrencies as forms of payment, the tax implications of using cryptocurrencies are a hot-button issue for the IRS.

The 2020 version of IRS Form 1040 (the form you recently filed or will file soon) asks whether you received, sold, sent, exchanged, or otherwise acquired—at any time during the year—any financial interest in any virtual currency. If you did, you are supposed to check the "Yes" box.

The fact that this question appears on page 1 of Form 1040, right below the lines for supplying taxpayer information such as your name and address, indicates that the IRS is getting serious about enforcing compliance with the applicable tax rules. Fair warning!

The 2020 Form 1040 instructions clarify that virtual currency transactions for which you should check the "Yes" box include but are not limited to

1. the receipt or transfer of virtual currency for free (i.e., without having to pay),
2. the exchange of virtual currency for goods or services,
3. the sale of virtual currency,
4. the exchange of virtual currency for other property, and
5. the disposition of a financial interest in virtual currency.

To arrive at the federal income tax results of a cryptocurrency transaction, the first step is to calculate the fair market value (FMV), measured in U.S. dollars, of the cryptocurrency on the date you receive it and on the date you use it to pay something.

When you exchange cryptocurrency for other property, including U.S. dollars, a different cryptocurrency, services, or whatever, you must recognize taxable gain or loss just as you do when you make a stock sale in your taxable brokerage account.

- You'll have a taxable gain if the FMV of what you receive exceeds your basis in the cryptocurrency that you exchanged.
- You'll have a taxable loss if the FMV of what you receive is less than your basis in the cryptocurrency.

It is hard to imagine that a cryptocurrency holding will be classified for federal income tax purposes as anything other than a capital asset—even if you use it to conduct business or personal transactions, as opposed to holding it for investment. Therefore, the taxable gain or loss from exchanging a cryptocurrency will be a short-term capital gain or loss or a long-term capital gain or loss, depending on how long you held the cryptocurrency before using it in a transaction.

Example. You use one bitcoin to buy tax-deductible supplies for your booming sole proprietorship business. On the date of the purchase, bitcoins are worth $55,000 each. So, you have a business deduction of $55,000.

But there's another piece to this transaction: the tax gain or loss from holding the bitcoin and then spending it.

Say you bought the bitcoin in January of this year for only $31,000. You have a $24,000 taxable gain from appreciation in the value of the bitcoin ($55,000 - $31,000). The $24,000 gain is a short-term capital gain because you did not hold the bitcoin for more than one year.

Detailed records are essential for compliance. Your records should include

- the date when you received the cryptocurrency,
- its FMV on the date of receipt,
- the FMV on the date you exchanged it (for U.S. dollars or whatever),
- the cryptocurrency trading exchange that you used to determine FMV, and
- your purpose for holding the currency (business, investment, or personal use).