*By Jon Sluis, columnist*

# CRYPTOCURRENCY IS NOT A CURRENCY

## *How the IRS treats your bitcoin exchanges*

Most people have heard the buzz around cryptocurrency. It can sound make-believe, complicated, intriguing, or scary, depending on what you know or don't know about it.

Some won't ever consider utilizing cryptocurrency; others have launched headlong into using it. We aren't here to debate the merits of cryptocurrency or which particular coin is better than another, but there are a few tax implications that are important for you to understand before jumping in.

Cryptocurrency (or virtual currency, as the IRS calls it) is not currency; rather, it is treated by the IRS as property. When you trade one currency for another (say $1 for four quarters), there generally is not a taxable event due to the classification of both as currency.

However, since virtual currencies are treated as property, every transaction is considered a taxable event. Thus an exchange of bitcoin into Ethereum is a taxable event, and either gain or loss would be recognized.

The best way to think of cryptocurrency is not as a currency. Instead, compare it to stocks or bonds within your investment portfolio. If you traded shares of Microsoft for shares of Apple, there likely would be a taxable event.

Unlike transactions within your investment portfolio where all the cost basis and transactional record-keeping are done for you, reporting is not required and thus often not done. You are responsible for tracking your cost basis and each transaction to determine appropriate gains and losses.

With the recent passage of the Infrastructure Bill, reporting requirements are slated to increase for certain U.S.-based entities, but details are still being worked out. As such, you should plan on tracking all of your cost basis amounts.

We can't stress this enough: Imagine having to track everything within your investment portfolio, including stock splits, dividend re-investments and sales transactions. There are third-party services and software packages that can help accumulate all of the activity; however, these are services you will likely need to seek out sooner rather than waiting for them to mail you a year-end statement.

Like stocks and bonds where investors can earn a return on their capital (referred to as interest and dividends), virtual currency holders can see a similar type of return. Within virtual currency, this is often referred to as "staking." Like interest and dividends, which have a different tax treatment than the actual investment, proceeds from staking have another tax treatment. Proceeds from staking activities are often treated as ordinary (versus capital gain in nature) and taxed at higher rates. Further complicating this, each transaction created by earning the proceeds from staking, in turn, has the potential to impact another taxable transaction if it is converted from virtual currency to another form of currency.

When you hold property investments, you generally know where they are located.

You can walk on your land, and you can see your buildings. Most individuals own their investment portfolios within U.S.-based financial institutions. Have you considered where your virtual currency is held? Is it with you or on a server in another country if you have your virtual currency wallet? If you use a service to hold the currencies, are they a U.S.-based firm or located within another country?

And depending on the level and amount of your underlying holdings, consideration of foreign reporting requirements should be made. There are multiple thresholds and ownership tests, so foreign reporting is not always required. However, if you hold (or held at any time during the year) more than $10,000, disclosure is something you should consider.

We don't want to discourage you from investing in cryptocurrency as there are also many advantages, including some especially related to tax strategies. One such example is the currently available loophole for generating taxable losses by recognizing sales transactions that are then not limited by wash sale limitations.

Due to all the above, plus many other topics that we haven't touched on, the IRS has estimated that under-reporting and incorrect reporting of virtual currency transactions is rampant (whether intentional or unintentional). For this reason, there is a heightened level of interest in virtual currency by the IRS and thus a heightened level of audit and compliance risk associated with its use.

Whether to mitigate unknown tax liabilities or take full advantage of some of the tax opportunities, if you have not considered the tax ramifications of your cryptocurrency transactions, you should do so soon.

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### How much do you know about cryptocurrency?

**1.** Cryptocurrency:
1. Is taxed like a currency.
2. Is taxed like a stock.
3. Is not taxed.

**2.** You don't have to do anything special for tracking tax reporting gains and losses in cryptocurrency. It's done for you, like stocks are.

1. True.
2. False.

**3.** This happens whenever a community makes a change to the blockchain's protocol, or basic set of rules.

1. A spoon.
2. A fork.
3. A knife.

Answers: 1: 2; 2: 2; 3: 2