



Digital Assets

Butler Accounting & Taxes Inc.
28 W 583 Stafford Place
Warrenville, IL 60555
630-393-0334 Website : Butlertaxes.net
Mobile: 630-476-0334 Fax: 630-393-7948

Digital Assets

A digital asset is any digital representation of value which is recorded on a cryptographically secured distributed ledger or similar technology. The term includes virtual currencies and may also include non-fungible tokens (NFTs). If a particular asset has the characteristics of a digital asset, it will be treated as a digital asset for federal income tax purposes.

Taxation

For federal tax purposes, digital assets are treated as property. Taxable transactions include:

- Receipt of digital assets as payment for property or services; as a reward or award; from mining, staking, or similar activities; or as the result of a hard fork,
- Sale of a digital asset,
- Transfer of digital assets for free (without consideration) as a bona fide gift,
- Disposal of digital assets in exchange for property or services, or in exchange for another digital asset, or
- Any other disposal of a financial interest in a digital asset.

Fair Market Value (FMV)

For federal income tax purposes, transactions using digital assets must be reported in U.S. dollars. You will be required to determine the FMV as of the date of payment or receipt of the digital asset.

Virtual Currency

Virtual currency is a digital asset. It is not legal tender in most countries and is not backed by a central government or bank. It is a digital representation of value that functions as a medium of exchange, a unit of account, and a store of value other than a representation of the U.S. dollar or a foreign currency.

Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Units of cryptocurrency are generally referred to as coins or tokens.

Exchange of Digital Assets for Goods or Services

If you receive any digital asset(s) as compensation for services, or dispose of any digital asset(s) held for sale to customers in a trade or business, you must report the income as you would report other income of the same type.

Barter income. When you barter with someone you are exchanging one good or service for another without the payment of money. The FMV of virtual currency received in a barter exchange is subject to income tax as if it was U.S. dollars. The FMV of the virtual currency received in the course of a trade or business must be included in business income in the year of receipt and is subject to self-employment tax.

***Example:** Jill has a cleaning business. She cleans George's house for a year in exchange for cryptocurrency. The FMV of the cryptocurrency when received is \$15,000. Jill recognizes \$15,000 as business income on her tax return even though she did not receive any U.S. dollars.*

Employees. The FMV of virtual currency paid as wages is subject to federal income tax withholding, FICA tax, and unemployment taxes. It also must be reported on Form W-2, *Wage and Tax Statement*.

Sale, Exchange, Disposition of Digital Assets

You generally recognize capital gain or loss on the sale, exchange, or disposition of digital assets that are held as a capital investment (investment property). Transactions using digital assets must be reported in U.S. dollars as of the date of the transaction to determine gain or loss. The holding period begins the day after the digital assets are



Digital Assets

received and must be held longer than one year to be considered a long-term capital gain or loss. Capital gain or loss from digital asset transactions is calculated and reported on Form 8949, *Sales and Other Dispositions of Capital Assets*, and then summarized on Schedule D (Form 1040), *Capital Gains and Losses*. If you transfer property that is not a capital asset in exchange for a digital asset, you will recognize an ordinary gain or loss.

Note: Many cryptocurrencies are available through online exchanges, such as Coinbase or Gemini. You should ensure that the trading platform you are using maintains purchase and sale records for you or you should maintain your own transaction histories. Online cryptocurrency tracking services are available that can help you track the needed information and facilitate tax reporting.

Mining Virtual Currency

Miners. Mining is a process through which blockchain transactions are verified and accepted by adding such transactions to a blockchain ledger. Miners use computers to solve mathematical equations that are part of the encryption process. The first miner who solves the transaction and validates it receives a digital token of virtual currency as a reward.

Gross income is realized upon the receipt of the digital token. The FMV of the virtual currency as of the date of receipt is includible in gross income. If you are in the trade or business of mining, the gross income is net earnings from self-employment and subject to self-employment tax.

Hardforks and air drops. When new cryptocurrency is split off from existing cryptocurrency the tax impact varies depending on timing. A hard fork (creation of new cryptocurrency) may be followed by an airdrop (distribution to ledger account), which results in taxable income. You have constructive receipt from an airdrop at the time it is recorded on the distributed ledger or earlier if able to exercise control. You do not have gross income as a result of a hard fork if you do not receive units of a new cryptocurrency.

You will have ordinary income equal to the FMV of the new cryptocurrency upon constructive receipt. Your basis for the new cryptocurrency is the amount included in income. Ordinary income from virtual currency is reported on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*.

Example: Brenda holds 50 units of Crypto R. On August 1, 2024, the distributed ledger for Crypto R experiences a hard fork, resulting in the creation of Crypto S. On that same date, 25 units of Crypto S are airdropped to Brenda's distributed ledger address. She has the ability to dispose of Crypto S immediately following the airdrop. Brenda now holds 50 units of Crypto R and 25 units of Crypto S. On August 1, 2024, the airdrop of Brenda's 25 units of Crypto S is recorded in the distributed ledger with a value of \$50. Brenda must report ordinary income of \$50 for tax year 2024 because she immediately has the ability to dispose of Crypto S. Brenda's tax basis in Crypto S is \$50, the amount of income recognized in the transaction.

Constructive receipt. You generally have constructive receipt of virtual currency from an airdrop on the date and at the time it is recorded on the distributed ledger. However, you may constructively receive virtual currency prior to the airdrop being recorded on the distributed ledger if you are able to exercise dominion and control over the virtual currency. Likewise, you do not have receipt of virtual currency when the airdrop is recorded on the distributed ledger if you are not able to exercise dominion and control over it.

For example, you do not have dominion and control if the address to which the cryptocurrency is airdropped is contained in a wallet managed through a virtual currency exchange which does not support the newly-created virtual currency such that the airdropped virtual currency is not immediately credited to your account. If you later acquire the ability to transfer, sell, exchange, or otherwise dispose of the virtual currency, you have constructive receipt at that time.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 73.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

Copyright © 2024 Tax Materials, Inc.
All Rights Reserved