Podcast: DeFi and Tax: How are digital currencies treated by the IRS?

October 27, 2022

Cryptocurrency has gained in popularity. Many finance companies have begun offering digital loyalty points and rewards. This sounds appealing until it's time to figure out how and when digital currency may be taxed.

Aaron Kouhoupt: I'm Aaron Kouhoupt, a member in McGlinchey's Financial Institutions Compliance team here in our Cleveland office. And I'm joined today by Doug Charnas, a nationally recognized tax attorney and member in McGlinchey's Washington, DC office. Doug spent six years as an attorney in the Office of the Chief Counsel to the IRS and has a really good understanding, maybe better than most, on how the inner workings of the tax code work. I'm pleased to have him here today to talk to us about the implications of cryptocurrency and digital currency in the tax world. Thank you for being with us today, Doug.

Douglas Charnas: I'm delighted to join you, Aaron.

Aaron Kouhoupt: So we've talked a lot during our Deep Dive series about how digital and virtual currencies and cryptocurrency differ from fiat currency. And as a reminder for everybody, fiat currency is a government-backed dollar, or government-backed coin, and we've really talked about how that differs. Our question today is, how does that play out in the tax space?

The most important thing to understand about digital currency or cryptocurrency is that it is treated as property for tax purposes. When you acquire cryptocurrency, your tax basis in that cryptocurrency is the fair market value of the cryptocurrency at the time that you acquire it.

Douglas Charnas: Aaron, the most important thing to understand about digital currency or cryptocurrency (and I tend to refer to it as cryptocurrency, so I'll use that term) is that it is treated as property for tax purposes. And what that means is that when you acquire cryptocurrency, your tax basis in that cryptocurrency is the fair market value of the cryptocurrency at the time that you acquire it. And over time, the fair market value of cryptocurrency as compared to fiat or U.S. currency is going to vary. Whereas if you have a dollar, your tax basis in the dollar is $1, and the value of that dollar is not going to vary over time for tax purposes.

So let's look at a couple of scenarios. Let's assume that you perform services; the value of those services is $1,000. You receive $1,000 U.S. dollars; you have $1,000 of income. Instead of receiving U.S. dollars, you receive $1,000 worth of cryptocurrency. You also have $1,000 of income, but your tax basis in that cryptocurrency is now $1,000. That's not going to change, but the value of that cryptocurrency is going to vary against the U.S. dollar, whereas the amount of U.S. dollars that you receive, the $1,000, that's not going to vary. It's always going to be $1,000.

The mere purchase of a good or service with cryptocurrency in and of itself can trigger a tax liability, where that never happens with the U.S. dollar.

Aaron Kouhoupt: So Doug, if I'm understanding that correctly, I just want to restate it as a very much non-tax guy. If I receive $1,000 in cash, U.S. dollars, and I hold onto that for a year; it's still going to be worth $1,000. If I receive cryptocurrency in the value of $1,000 equivalency, but it's a cryptocurrency, $1,000 worth of cryptocurrency, and that cryptocurrency increases in value. So I have one Bitcoin, and the one Bitcoin's worth $1,000, that Bitcoin goes up to $1,400, and I sell it. Does that mean I have $400 worth of taxable income because the fair market value of the crypto went from $1,000 to $1,400 when I sold it?

Douglas Charnas: Yes. That means that you have a gain, and depending upon how long you hold that cryptocurrency and whether that cryptocurrency is a capital asset for you, you may have short-term capital gain or long-term capital gain, and the tax rates will vary. You can really understand this if we put it into the context of the $1,000 that you got for performing the services. If you go and now purchase something with that $1,000, so let's say that you're going to a hotel and you want to use your $1,000 to pay for the room and you're going to stay there for a few days. So the cost of the room is going to be $2,000. Well, if you're using U.S. dollars, that means you're going to have the $1,000 that you earned, and you're going to need another $1,000 to pay for the hotel room. So you're going to pay $2,000.

But when you do that, you are not going to incur any tax liability because you're using U.S. dollars. But let's go back and say that $1,000 of cryptocurrency that you received when you performed those services has now increased to $2,000, and you're going to pay for that hotel room with that cryptocurrency. Well, what's happening is you're now going to get taxed on that $1,000 increase from the original fair market value of that cryptocurrency when you perform the service, to the now fair market value when you are using that cryptocurrency to pay for the hotel room. So the mere purchase of a good or service with cryptocurrency in and of itself can trigger a tax liability, where that never happens with the U.S. dollar.

The whole area of loyalty programs and rewards is one for which we do not have much guidance from the Internal Revenue Service. It's a complicated area because it depends on why you're getting the reward.

Aaron Kouhoupt: Right. That makes a lot of sense and is very good to know. So another thing that we're seeing a lot in the market is, you know, we see a bunch of companies, typical traditional consumer finance companies or maybe alternative consumer finance companies, that are offering cryptocurrency as a reward. And so think about your, you know, Delta miles or your Hilton honor points. This is similar in the sense that I use a credit card or I use a debit card, and I earn $1 of crypto every time I make $10 worth of purchases with my card. How is the crypto taxed from that perspective? If I'm earning the cryptocurrency as a reward, what is the impact to me there?

Douglas Charnas: The whole area of loyalty programs and rewards is one for which we do not have much guidance from the Internal Revenue Service. We have some guidance, but not a whole lot. It's a complicated area because it depends on why you're getting the reward. If you are purchasing something, you're using your credit card, for example, and you're acquiring goods, you're also going to be incurring service charges and interest. That's the purchase of a good or service. And when you receive a reward in connection with the purchase of a good or service, the reward is treated as actually an adjustment to the purchase price. So the receipt of that award in those situations does not trigger income for you. It's really going to be a reduction in the item that you purchased. The IRS, in its Publication 17, which is sort of its general publication of the tax law for individuals, provides an example.

One example of a reward that actually triggered income for the recipient was a thank you point reward for airline miles that was provided by a bank.

And there, it gives an example of a rebate by an automobile manufacturer. You have a car worth $24,000; you purchase that car, you get a $2,000 rebate from the manufacturer. Well, that rebate that you receive, and it may be a cash rebate, is not income to you. It's just a reduction in the purchase price of that automobile. So now your tax basis in that automobile is $22,000 because you reduce the $24,000 by the $2,000. In that context, you don't have gain. And it doesn't matter whether you're getting cash or you're getting cryptocurrency; it's going to be no income to you. But the difference again is that when you get that cryptocurrency, that is worth $2,000. That's your tax basis in that $2,000. So if you now go out and you spend that reward that you've received, and in your context, it's coming from a financial institution, then you may have gain or conceivably loss, because you're going to look at what's the fair market value of that reward at the time that you use it compared to your tax basis.

There's a different scenario which adds to the complexity, and that's a situation in which you get cryptocurrency or even U.S. currency for doing something, but you're not purchasing a good or service. One example of a reward that actually triggered income for the recipient was a thank you point reward for airline miles that was provided by a bank. And when that individual received that, there was going to be a question of whether he had taxable income when he used that thank you reward to get airline miles, and the Tax Court, in looking at that case, said yes, there was income at that time. So the area is a little bit complicated. What adds to the complexity for cryptocurrency or any type of virtual currency is that you have to track the basis in that cryptocurrency. So whenever you then spend it, now you have to know, for that particular cryptocurrency, what was my tax basis in that?

The IRS recently released a draft of the 1040, the individual income tax return, and the (revised) question is, have you received digital currency, or have you spent it? And it's a yes or no question; there's nothing beyond that.

And when I go to spend it, is that going to trigger gain or loss for me? And this is the area that's creating a lot of administrative burden on taxpayers and the IRS. It's the tracking of that cryptocurrency tax basis. The IRS recently released a draft of the 1040, the individual income tax return, and it has revised the question that it has for virtual, or they refer to it as "digital currency." And that question is on the return, right below where you fill out your name and your social security number and your address. So it's really the first question on the tax return. And the question is, have you received digital currency, or have you spent it? And it's a yes or no question; there's nothing beyond that. But what that's telling the IRS is that you're dealing with cryptocurrency and that you may have gain or loss as a result of that.

Aaron Kouhoupt: Thanks, Doug. So if I take the two things that you said together, what I think I'm hearing is that, and let's stick in this reward section for a second, the timing of the purchase by the entity that's going to grant the reward and the timing by which the ownership of the cryptocurrency exchanges hands becomes a little bit important. Because if I'm the entity and I buy cryptocurrency, but I maintain ownership of that cryptocurrency, let's say I don't transfer the crypto reward to Doug until 60 days down the road, I, as the entity, hold that cryptocurrency for 60 days. I own that cryptocurrency for 60 days, and if that cryptocurrency goes up or down during those 60 day period, it sounds like there could be a taxable event there for me as the entity holding the cryptocurrency that I just purchased on behalf of the consumer. Or I transfer the value of that cryptocurrency immediately to Doug, in which case Doug then has the potential tax implication as to whether or not that cryptocurrency is going to go up or down. So it sounds like there could be some important timing considerations from an accounting and financial perspective, as to when that cryptocurrency is actually purchased and then when the ownership of the cryptocurrency changes hands to establish that basis of the fair market value of the cryptocurrency.

The timing of the purchase by the entity that's going to grant the reward and the timing by which the ownership of the cryptocurrency exchanges hands becomes important.

Douglas Charnas: That's absolutely right, and that's why it's so important to have a system set up to track all of these events. You need to know what the fair market value is at the time that you acquire the cryptocurrency to use it. And then you need to know because that establishes your tax basis. And then, you need to know what the fair market value of it is when you transfer it. Because as you said, Aaron, that's going to determine whether you have gain or loss on that transfer.

Aaron Kouhoupt: That all sounds interesting and complicated, and I think that it seems pretty clear to me that the best move you can make either as an entity that's granting rewards and buying cryptocurrency on behalf of another or if you're a consumer earning cryptocurrency through a reward just every day, right, just getting cryptocurrency, that you might want to talk to your tax advisor at the end of the year about what the implications are.

You need to know what the fair market value is at the time that you acquire the cryptocurrency to use it. You need to know because that establishes your tax basis. You need to know what the fair market value of it is when you transfer it. That's going to determine whether you have gain or loss on that transfer.

Douglas Charnas: That's absolutely right. And you're going to need to have good records. And I think what concerns me is that the burden of establishing what the fair market value was at the time that you acquired it for purposes of knowing whether you have gain or loss when you dispose of it is going to be on the taxpayer. If the taxpayer is being audited by the Internal Revenue Service, the Internal Revenue Service may take the position that the basis is zero, unless you can establish to me otherwise.

Aaron Kouhoupt: Thank you very much for being with us again today, Doug, and talking about these issues. And if anybody has any questions, feel free to reach out to Doug or myself, and I can get you in touch with Doug, because you don't want me giving you tax advice. Online tax preparing software is the way I go. So we'll get you in touch with Doug, and he'll help you out.

Douglas Charnas: Glad to be with you, Aaron. Take care. Thanks.

Aaron Kouhoupt: Thanks.

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