

Chapter 2: Individual Taxpayer Issues

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Please note. Corrections for all of the chapters are available at www.TaxSchool.illinois.edu. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see [uofi.tax/xxx](#), the link points to the address immediately following in brackets.

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CYBERCURRENCY

Cybercurrency (or cryptocurrency) is virtual or digital currency that functions as a medium of exchange, unit of account, and/or a store of value.¹ In some environments, it acts like “real” currency, except cybercurrency does not have legal tender status in any jurisdiction. The terms cybercurrency and virtual currency are used synonymously throughout this section.

Cybercurrency can be digitally traded between users and exchanged into U.S. dollars and other real or virtual currencies² or exchanged for goods and services.³ For example, retailers including Expedia.com, Microsoft, Overstock.com, and Dish Network accept payment in cybercurrency.⁴

There are thousands of types of cybercurrency. Popular examples include Bitcoin, Ripple, Ethereum, and Litecoin.⁵

Note. Virtual currency is a general term for all forms of intangible money. Cryptocurrency is a specific type of virtual currency characterized by privacy, decentralization, security, and encryption.⁶

To establish an account for cybercurrency, users make a deposit into a digital wallet from a bank account or credit/debit card.⁷ Once the account is funded, traditional currency can be exchanged for cybercurrency.⁸

Note. The terms “digital wallet” and “virtual wallet” are used synonymously in this chapter.

The total value of all outstanding cybercurrency offerings approached \$1 trillion as of early 2018.⁹ With the high value and anonymous nature of virtual currency, the IRS has taken notice and is providing guidance for miners (discussed later), investors, merchants, and spenders of cybercurrency. However, many taxpayers and tax professionals are still uncertain as to how to treat cybercurrency.

TAX TREATMENT¹⁰

The IRS issued Notice 2014-21 to provide guidance on some basic tax principles concerning virtual currency. The notice establishes that **virtual currency is treated as property**. As property, the tax treatment depends on the manner in which the holder uses the cybercurrency.

¹ IRS Notice 2014-21, 2014-16 IRB 938.

² Ibid.

³ *Cryptocurrency and taxes*. Smalley, Craig W. Apr. 20, 2017. The Tax Adviser. [www.thetaxadviser.com/newsletters/2017/apr/cryptocurrency-taxes.html] Accessed on Mar. 28, 2018.

⁴ *13 Major Retailers and Services That Accept Bitcoin*. Moreau, Elise. Mar. 7, 2018. Lifewire. [www.lifewire.com/big-sites-that-accept-bitcoin-payments-3485965] Accessed on Mar. 28, 2018.

⁵ *List of cryptocurrencies*. Wikipedia. [en.wikipedia.org/wiki/List_of_cryptocurrencies] Accessed on Mar. 28, 2018.

⁶ *Cryptocurrency Vs Digital Currency – How Virtual Money Works?* Bitcoin Exchange Guide. [bitcoinexchangeguide.com/cryptocurrency-vs-digital-currency/] Accessed on Apr. 2, 2018.

⁷ *Accepted credit/debit cards*. Coinmama. [support.coinmama.com/hc/en-us/articles/212412145-Accepted-credit-debit-cards] Accessed on Apr. 2, 2018; *How to Buy Bitcoin*. CEX.IO. [cex.io/buy-bitcoins] Accessed on Apr. 2, 2018.

⁸ *What is bitcoin? Here's everything you need to know*. Jaffe, Justin. Feb. 12, 2018. Cnet. [www.cnet.com/how-to/what-is-bitcoin/] Accessed on Mar. 12, 2018.

⁹ *Want to Mine Ripple? Think Again*. Caplinger, Dan. Jan. 16, 2018. The Motley Fool. [www.fool.com/investing/2018/01/16/want-to-mine-ripple-think-again.aspx] Accessed on Mar. 12, 2018.

¹⁰ IRS Notice 2014-21, 2014-16 IRB 938.

Personal Use

Because it is property, cybercurrency held for personal purposes, pleasure, or investment is a capital asset.¹¹ The taxpayer has a capital gain on cybercurrency if the fair market value (FMV) of the property or cash received exceeds the adjusted basis of the cybercurrency exchanged. The taxpayer has a capital loss on cybercurrency if the basis of the cybercurrency exchanged is greater than the FMV of the property or cash received. A loss from the sale or exchange of personal-use property is **not deductible**.

Example 1. Bruno paid \$5,000 for the Ripple he had in his digital wallet. The value of his Ripple declined to \$3,000, and Bruno uses the Ripple to purchase a camera with an FMV of \$3,000. He incurred a \$2,000 nondeductible capital loss.

A taxpayer who receives cybercurrency as payment for goods or services must include the FMV of the cybercurrency in their gross income. The FMV is measured in U.S. dollars as of the date the cybercurrency is credited to the taxpayer's digital wallet. The taxpayer must establish FMV using a reasonable manner that is consistently applied.

Note. There are a number of websites that publish current and historical values for various cybercurrencies that taxpayers can use to calculate basis. One popular website is **coinmarketcap.com**.

Recordkeeping can be tedious because cybercurrency is maintained in fractional shares. For example, the smallest denomination of bitcoin is one hundred millionth of a share.¹² Tax preparers should obtain documentation on all virtual currency transactions such as printouts of virtual wallets, purchases, and exchanges to ensure proper recordkeeping.¹³

Example 2. Iris purchases a bitcoin (BTC) to use in lieu of cash in her hobby of taking wildlife photographs. She maintains the following ledger.

Date	Transaction	Amount	Fee	BTC Used	BTC Balance
1/14/17	Fund Coinbase account	\$820	\$12		0
1/14/17	Purchase 1 BTC	(\$808)			1.00000000
3/5/17	Purchase hotel room expedia.com (1 BTC = \$1,267)	(\$200)		0.15785320 (\$200 ÷ \$1,267)	0.84214680
2/11/18	Purchase camera lens Overstock.com (1 BTC = \$8,130)	(\$175)		0.02152522 (\$175 ÷ \$8,130)	0.82062158

Iris calculates her gain as follows.

Description	Acquisition Date	Sale/Disposal Date	Proceeds	Basis	Gain/(Loss)
2017 short-term capital gain					
0.15785320 BTC	1/14/17	3/5/17	\$200	\$129.44 (0.15785320 BTC × \$820 basis)	\$ 70.56
2018 long-term capital gain					
0.02152522 BTC	1/14/17	2/11/18	\$175	\$17.65 (0.02152522 BTC × \$820 basis)	\$157.35

¹¹ See IRS Pub. 544, *Sales and Other Dispositions of Assets*.

¹² *Satoshi*. Investopedia. [www.investopedia.com/terms/s/satoshi.asp] Accessed on Apr. 2, 2018.

¹³ *Documenting Virtual Currency Transactions*. Adams, Edwards W. and Sumutka, Alan R. Jan. 1, 2018. Journal of Accountancy. [www.journalofaccountancy.com/issues/2018/jan/documenting-virtual-currency-transactions.html] Accessed on Feb. 28, 2018.

Note. A taxpayer who purchases goods or services using cybercurrency may owe state sales or use tax.¹⁴

Guidance needed. In response to IRS Notice 2014-21, the American Bar Association Section of Taxation and the American Institute of Certified Public Accountants (AICPA) both recommended the IRS institute a de minimis exception for the value that needs to be reported and guidance on recordkeeping to reduce administrative burden.¹⁵ The AICPA looks to the IRC §988(e)(2) exclusion of up to \$200 per transaction for foreign currency exchange rate gain as a model. As of the date of publication, the IRS has not issued any additional guidance.

In the event that regulations or other guidance are issued too late to be included in this workbook, coverage will be provided in the form of a supplement, which can be downloaded at uofi.tax/supplement.

Investors

Investors acquire cybercurrency through buying, selling, and storing virtual currency on a cybercurrency exchange, such as Coinbase.¹⁶ Gains and losses on cybercurrency are treated as property and generate capital gains or losses. The investor's holding period determines whether such gain or losses are short- or long-term. The holding period starts the day after the cybercurrency is acquired and ends on the date of sale or disposal.¹⁷ Long-term capital gains are gains from the sale or exchange of a capital asset held for more than one year¹⁸ and they receive beneficial tax treatment under IRC §1(h). Short-term gains are gains on the sale or exchange of a capital asset held for less than one year¹⁹ and they do not receive beneficial tax treatment. Net capital losses on investment property are generally limited to \$3,000 per year with any unused loss carried forward to the next year.²⁰

The IRS has not issued guidance on identifying the basis for cybercurrency. Often, cybercurrency is acquired over time in fractional units. It is challenging to determine out of which lot a fraction of a unit of cybercurrency was sold unless the seller maintains precise inventory records. Specific identification requires detailed recordkeeping to track each specific lot, and current technology may not be able to track exactly which unit of cybercurrency is being exchanged in a particular transaction.²¹

¹⁴ *The Basics of Cryptocurrencies And Taxes*. Cryptocurrency Facts. [cryptocurrencyfacts.com/the-basics-of-cryptocurrencies-and-taxes/] Accessed on Apr. 4, 2018.

¹⁵ *Comments on Notice 2014-21: Virtual Currency Guidance*. Jun. 10, 2016. AICPA. [www.aicpa.org/advocacy/tax/downloadabledocuments/aicpa-comment-letter-on-notice-2014-21-virtual-currency-6-10-16.pdf] Accessed on Mar. 15, 2018; *Comments on Notice 2014-21*. Mar. 24, 2015. American Bar Association Section of Taxation. [apps.americanbar.org/dch/thedl.cfm?filename=/TX334600/sitesofinterest_files/BitcoinComments.pdf] Accessed on Mar. 15, 2018.

¹⁶ *What is bitcoin? Here's everything you need to know*. Jaffe, Justin. Feb. 12, 2018. Cnet. [www.cnet.com/how-to/what-is-bitcoin/] Accessed on Mar. 12, 2018.

¹⁷ IRC §1223; IRS Pub. 544, *Sales and Other Dispositions of Assets; Counting Cryptocurrency Gains And Losses Without Running Afoul Of IRS Rules*. Bergman, Adam. Jan. 12, 2018. Forbes. [www.forbes.com/sites/greatspeculations/2018/01/12/counting-cryptocurrency-gains-and-losses-without-running-afoul-of-irs-rules/#30e1bae01a61] Accessed on Apr. 4, 2018.

¹⁸ IRC §1222.

¹⁹ *Ibid.*

²⁰ IRC §1211.

²¹ Richman, Nathan. (2018, Mar. 5). Virtual Currencies Raise Difficult Inventory Accounting Questions. *Tax Notes Today*.