What Business Leaders Need to Know About Cryptocurrency Audits

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What is mining? An online search will reveal the traditional definition of mineral excavations, but subsequent results will point to bitcoin mining or cryptocurrency mining.

Cryptocurrency, or crypto mining, refers to the use of graphics cards and high-powered computing to verify transactions. These transactions are added to a public ledger, known as a blockchain. When a transaction is successfully verified, a user is rewarded in cryptocurrency.

What makes crypto so appealing is that anyone with access to the Internet and suitable hardware can mine.

At the same time, the tax issues behind crypto mining can be complex, making processes like an IRS tax audit seem daunting. However, there is existing guidance that can simplify compliance and may produce successful tax audits.

While there are no tax regulations written yet on the rules around cryptocurrency taxation, the IRS issued some guidance under Tax Notice 2014-21 that provides more clarity on how to treat virtual currency. It’s important to note that while the guidance may seem clear, it is just the IRS’s general interpretation of the law. It makes sense then to walk through some questions that may come up during a tax audit.

Q: If I set up a crypto mining company (i.e. purchase graphics cards to “mine” virtual currency), can the receipt of the virtual currency be considered taxable income?

A: A taxpayer’s set of facts and circumstances should be carefully reviewed when interpreting Section Q-8 from the IRS Notice 2014-21, which states “yes, when a taxpayer successfully mines virtual currency, the fair market value of the virtual currency on the date of receipt is includible in gross income.”

Q: If I mine virtual currency and determine it is includible as income, will that income be subject to self-employment tax?

A: This will likely depend on the nature of your activities and may also depend on the type of entity you set up to perform the “mining” activities. A review of Section Q-9 from the notice helps to shed some light on this issue, highlighting that it may depend on whether your “mining of virtual currency constitutes a trade or business” and whether the taxpayer is considered an employee.

Q: Is my income from mining subject to ordinary or capital gains?

A: Under Section Q-7 of the notice, it states that “the character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer.” Some things to consider when making this determination is whether the virtual currency might be inventory used in a trade or business or if the asset is primarily held as an investment. The notice references Publication 544 for more information on capital assets and the character of gain or loss.

Other Important Questions to Consider

What happens when payments are made to employees using virtual currency? Should these payments be included on a W-2? Are these payments subject to withholding? Is a 1099-MISC required when paying a contractor with virtual currency?

These are all common questions to consider when dealing with cryptocurrency. It’s important to note that under Section Q-16 of the notice, taxpayers may be subject to penalties for failure to comply with tax laws, including underpayment and accuracy-related penalties under section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under section 6721 and 6722.

The Key to Crypto Audits

Crypto and blockchain are often thought of as uncharted territories where no rules apply. In fact, if you look close enough, there is some guidance that can be applied, which could result in successful outcomes for companies. Taxpayers should take the IRS approach to cryptocurrency seriously and seek out a CPA that has expertise in this area.

On May 16, the IRS published a letter acknowledging it is updating cryptocurrency tax guidelines and making it a priority. Its urgency proves the industry can expect more changes in the near future.

Navigating cryptocurrency audits can be a complex process, but BPM’s experts can help.
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