



Virtual Currency Taxation

Course #3321A

Taxes

2 Credit Hours

Support@PacificCPE.com | (800) 787-5313

PacificCPE.com

VIRTUAL CURRENCY TAXATION

Virtual currency use is increasing. As a result, tax preparers are more likely than ever to encounter clients who have engaged in one or more virtual currency transactions during the year and who may have taxable income as a result. This course discusses the nature of virtual currency, how transactions in virtual currency occur and are recorded, and the tax treatment to which they are subject.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Nature of Virtual Currency **Tax Treatment of Virtual Currency**

Study the course materials from pages 1 to 40

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recognize virtual currency.
- Recall how central bank digital currency (CBDC) is used.
- Identify how to calculate the adjusted cost basis of virtual currency that is purchased, mined, or received as a gift.
- Recall the tax treatment of virtual currency given as a charitable gift.

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Program publication date 12/7/22

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: NATURE OF VIRTUAL CURRENCY

Chapter Objectives

After completing this chapter, you should be able to:

- Recognize virtual currency.
- Recall how central bank digital currency (CBDC) is used.
- Recognize how stablecoins differ from unbacked cryptocurrency.
- Recall how virtual currency networks maintain security.
- Recognize how blockchain is employed with respect to virtual currency transactions.

INTRODUCTION

Virtual currency use appears to be increasing continually and, according to a Pew survey, roughly 3 in 10 Americans younger than age 30 indicate they have invested in, traded, or used a virtual currency, such as Bitcoin or Ethereum. As a result, tax preparers are more likely than ever to encounter clients who have engaged in one or more virtual currency transactions during the year and who may have taxable income as a result. This chapter begins the course with a discussion of the nature of virtual currency and how transactions in virtual currency occur and are recorded.

THE LEXICON OF VIRTUAL CURRENCY

Understanding the U.S. tax treatment of virtual currency requires that we have an understanding of the nature of virtual currency which, in turn, means we need to understand the terms and language used to describe it and the ecosystem in which it exists. To that end, the lexicon, based on the Blockchain Universal Glossary published by the Association of International Certified Professional Accountants is included in the Glossary¹ and is used in the following text.

VIRTUAL CURRENCY DEFINED

With the flurry of types of currency mentioned in conversations—digital currency, virtual currency, cryptocurrency, and the like—it's often difficult to be sure what people mean when they talk about it. Virtual currency was initially defined by the European Central Bank in a 2012 report² titled Virtual Currency Schemes as “a type of unregulated, digital money, which is issued and usually controlled by its developers, and used and accepted among the members of a specific virtual community.”

In 2014 the IRS, in Notice 2014-21, observed that “virtual currency... is customarily used and accepted as a medium of exchange in the country of issuance—but it does not have legal tender status in any

1. “Blockchain Universal Glossary” may be accessed at <https://us.aicpa.org/content/dam/aicpa/interestareas/informationtechnology/downloadabledocuments/blockchain-universal-glossary.pdf>

2. Virtual Currency Schemes may be accessed at <https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf>.

jurisdiction.”³ Similarly, in IRS Revenue Ruling 2019-24, the IRS declared that “Virtual currency is a digital representation of value... and a store of value other than a representation of the United States dollar or a foreign currency”⁴ and further went on to equate foreign currency with the money of a foreign country designated as legal tender. In short, it reiterated that virtual currency was not the legal tender of any foreign country.

In September, 2021 El Salvador made that statement incorrect by declaring Bitcoin legal tender, giving it a status in the country similar to the U.S. dollar. In light of the historically high level of remittances to Latin American countries and the costs and delays normally associated with cross-border payments, it is possible that virtual currency will become legal tender in additional Latin American and other countries as they observe the effect virtual currency’s status as legal tender has on El Salvador’s banking system and the well-being of its citizens.

One of the characteristics central to the ability of virtual currency to gain acceptance is its adherence to a set of rules to ensure the values recorded in the ledger memorializing virtual currency transactions are correct. That is accomplished through its consensus protocol, the mechanism defining the steps required to achieve agreement on the values recorded by the various participants on the blockchain. The term “protocol,” when used in this sense is generally defined as a set of rules governing the communication and transfer of data between machines, as in a computer system.

Digital Currency

The various notices, rulings and reports refer to virtual currency as “digital.” To forestall confusion and clearly identify the subject of this course, it’s appropriate to briefly examine the relationship of digital currency to virtual currency. Digital currency is a fairly broad term referring to a method of payment existing entirely in an electronic form. As an electronic method of payment, it is transferred to a payee using an online system.

CBDCs – Regulated Digital Currency

Digital currency may be regulated or unregulated. Regulated digital currency is currency issued by a country’s central bank and generally referred to as central bank digital currency (CBDC). Among other uses, CBDCs are employed for monetary transactions between banks and other financial institutions.

The Federal Reserve Board released a paper titled *Money and Payments: The U.S. Dollar in the Age of Digital Transformation* in January 2022, examining the pros and cons of a U.S. central bank digital currency⁵ and inviting public comments. The paper summarizes the domestic payments system, discussing the various digital payment methods and assets, including stablecoins and other types of cryptocurrencies. Without taking a position, the paper examines CBDCs, considers the potential benefits and risks their issuance poses, and identifies the policy considerations associated with such a step. For purposes of the paper, a CBDC is defined “as a digital liability of a central bank that is widely available to the general public. In this respect, it is analogous to a digital form of paper money.”

3. IRS Notice 2014-21 may be accessed at <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

4. IRS Revenue Ruling 2019-24 may be accessed at <https://www.irs.gov/pub/irs-drop/rr-19-24.pdf>.

5. *Money and Payments: The U.S. Dollar in the Age of Digital Transformation* may be accessed at <https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf>.

Although considerable international effort would be needed, CBDCs could facilitate cross-border payments and reduce costs through the use of new technologies, simplified distribution channels, and by creating additional opportunities for collaboration between countries.

Virtual Currency – Unregulated Digital Currency

Unlike CBDCs that are **regulated** digital currency, virtual currency is **unregulated** and may be either closed virtual currency—virtual currency that is used entirely in a controlled, private ecosystem and which cannot be converted into fiat currency—or open virtual currency. Open virtual currency, in contrast to closed virtual currency, is convertible into other forms of currency, including fiat and may be stablecoins or unbacked cryptocurrency.

Stablecoins – Backed Cryptocurrencies

Stablecoins are digital assets designed to maintain a stable value and are used in the United States to facilitate trading, lending, or borrowing of other digital assets. Although intended principally to provide stability and a level of safety when contrasted with unbacked cryptocurrency, stablecoins can vary from one another with respect to the risks they pose to holders because of the assets they hold as security. Thus, the reserve assets of some stablecoin arrangements are held in deposits at insured depository institutions or in U.S. Treasury bills, while other stablecoins may be backed by commercial paper, corporate and municipal bonds, and other digital assets. Although both offer safety and security uncharacteristic of cryptocurrency, the level of safety provided obviously varies.

As discussed in a FINRA investor insights report titled *Cryptocurrencies: Three Things to Know About Stablecoins* dated April 17, 2020,⁶ currently-available stablecoins fall into four main categories:

- **Fiat-backed stablecoins** - stablecoins secured by fiat currency are the most prevalent type of stablecoins currently available. Fiat-backed stablecoins are secured by one or more currencies, such as U.S. dollars, Euros, Yen, or some other central bank-issued currency. The value of a fiat-backed stablecoin is typically equal to the value of the collateral held in reserve;
- **Commodity-backed stablecoins** - stablecoins backed by commodities are tied to tangible assets, such as silver, gold, or other precious metal and are typically more attractive to investors looking for exposure to physical assets. The value of a commodity-backed stablecoin is normally equal to One unit of the commodity. So, in the case of a commodity-backed stablecoin secured by gold, its value might reasonably be worth one ounce of gold. Similarly, an oil-backed stablecoin could be worth one barrel of oil. The physical commodities used to secure commodity-backed stablecoins are usually held by a third party who stores the assets in reserve;
- **Crypto-backed stablecoins** – crypto-backed stablecoins, whose value may be pegged to a fiat currency, are secured by other digital currencies rather than by the fiat currency to which their value is referenced. However, possibly in recognition of the volatility of

6. *Cryptocurrencies: Three Things to Know About Stablecoins* may be accessed at <https://www.finra.org/investors/insights/3-things-stablecoins>.