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4 Key Tax Considerations For Cryptocurrency Contracts

By **Amy Lee Rosen**

Law360 (June 18, 2021, 5:01 PM EDT) -- When deciding whether to commit to a cryptocurrency contract, token holders should be aware of how they will monitor profits and losses, what tax forms they'll receive or need to provide, and growing government enforcement efforts in the space.

Here, Law360 explores four important items to think about when evaluating whether and how to create a contract that uses cryptocurrency.

Tracking Profits, Losses

A contract that involves cryptocurrency requires the normal contractual components of an offer, consideration and acceptance. However, token holders also need to understand that the transfer, sale, purchase or exchange of cryptocurrency also has tax consequences that need to be reported, according to Edward L. Froelich, of counsel at Morrison & Foerster LLP.

The first guidance released by the Internal Revenue Service on cryptocurrency was a 2014 notice that said any capital gain or loss from the sale or exchange of cryptocurrency has to be reported the same way as any other gain or loss on the sale or exchange of property. The notice said someone who has received cryptocurrency as payment for goods or services must calculate their gross income by including the fair market value of the token on the date it was received.

If a contract uses cryptocurrency as payment for a service or a good, then the holder would have to make sure they knew the basis in the token when they received it, then subtract that basis from the value of the good or service to determine the gain or loss that must be reported, Froelich said.

"So from the tax point of view, you're using a piece of property that has a basis … and there's a tax event that happens every single time when you, the buyer, use it," he said.

For example, if a contract allows for one bitcoin to be used to purchase a car, the contractual parties may not understand that the buyer has to report a capital gain on the disposition of the bitcoin, assuming the bitcoin appreciated since purchase and is held by the buyer as a capital asset, Froelich said.

"If I just went and bought a car with cash, there would be no tax implication, but there is when I use bitcoin," he said. "That's probably one of the things that will strike people as a little surprising that they're not [necessarily] understanding."

IRS Enforcement Efforts

Appropriate tax reporting is especially important when engaging in cryptocurrency contracts because the IRS has been ramping up enforcement in this area for quite some time, said Nicholas R. Rosado of Rosado Tax Law.

The IRS has been cracking down to increase tax compliance, as demonstrated by the agency sending 10,000 letters in 2019 warning cryptocurrency users to properly report and pay taxes on these transactions.

The IRS is getting much of its information about cryptocurrency users from summonses on cryptocurrency exchanges. A California federal judge told Coinbase in November 2017 that it must hand over information on accounts with transactions greater than $20,000 and must provide the taxpayer ID, name, date of birth and address for the accounts.

In May 2020, a California federal judge said the IRS could execute a John Doe summons on the cryptocurrency exchange Kraken Inc. to help the agency determine whether any of the company's users have tax obligations on their cryptocurrency trades.

Rosado, who previously worked as senior attorney at the IRS Office of Chief Counsel, said cryptocurrency tax enforcement has been increasing through the use of summonses, so anyone who is using cryptocurrency in their contracts needs to be aware of the government's actions in this space.

"The IRS is seeking additional powers in this area because it doesn't fall within the normal information reporting regime," he said. "And it seems like the IRS is becoming more aggressive in this area, from an enforcement side."

Contract Type

An agreement with cryptocurrency can be done through a regular contract or through a smart contract, which is done by taking a regular contract and turning it into a computer program that can execute the terms with limited or no intervention.

While a regular cryptocurrency contract contains clauses that must be analyzed by a decision-maker to determine whether conditions are met, a smart contract automatically determines whether conditions are met through code, said Andrew B. Gordon, managing attorney of Gordon Law Group. As such, smart contracts can help reduce some administrative burdens and potential disputes since they are self-executing, he said.

One of the most popular ways to create a smart contract is by using the Ethereum blockchain, which contains a collection of code and data that allows users of Ethereum tokens to send transactions over the network. User accounts can then interact with a smart contract by submitting transactions that execute a function defined on the smart contract, according to Ethereum's website.

While this system allows the use of blockchain code to create contracts that can pull external data to determine if conditions are met, users rarely and sometimes never even consider related tax consequences when they are figuring out how to use the system, Gordon said.

While those who use smart contracts still need to track tax consequences such as income, gain or loss, it is less clear what happens if the smart contract gives some type of participation token, which is a token received in exchange for participating in a smart contract, he said. Generally, if someone deposits Ethereum, they receive some type of token to represent their holdings in the transaction, but that receipt may have its own tax consequences, he said.

"Smart contracts are decentralized, so it's hard to identify the participants and who is involved, [which is why] sometimes you will get a token back to represent your participation," he said. "Arguably, that's a taxable event."

How to treat the receipt of this type of coin is a gray area, but most practitioners would say the contract token is a separate cryptocurrency asset that has its own basis and would later trigger a taxable gain or loss at disposition, Gordon said. However, there is no tradable market for these types of cryptocurrency contract coins, which makes it harder to determine the fair market value at receipt and therefore later to be able to calculate the reportable gain or loss, he said.

Information Reporting

It is also important to understand the tax information reporting that may be required for contracts, according to Rosado.

For example, if a business owner engages an independent contractor for services and the contractor is paid more than $600, then the owner must fill out a Form W-9 to get the contractor's tax identification number and determine if they are subject to backup withholding, he said. That form is required whether the contractor is paid in dollars or cryptocurrency, Rosado said.

Depending on whether backup withholding is necessary, the IRS may then require the payor to withhold tax and transmit it to Treasury, he said. After obtaining the Form W-9, the business owner must issue a Form 1099-MISC to the contractor informing them that they were paid and that the worker received self-employment income, Rosado said.

"So to the extent it's a commercial transaction for services, [those forms] will come into play," he said.

If instead a business is paying an employee's wages in cryptocurrency, that would require filing a Form W-2, Rosado said.

There could also be international reporting requirements that are triggered by a contract if it involves some sort of gift of cryptocurrency given through an estate, Rosado said. If someone receives a gift of cryptocurrency from a foreign person, under Internal Revenue Code Section 6039F the gift must be reported to the IRS on a Form 3520 if it exceeds $100,000, he said. That may happen, for example, if a smart contract were set up to automatically distribute cryptocurrency to a U.S. person upon the death of a foreign individual, he said.

"Any information reporting should match the transaction," he said. "The contractual parties do need to pay attention to the subject matter of the transaction to determine if it creates an information-reporting requirement for one, some, or all of the parties."

--Additional reporting by Joshua Rosenberg. Editing by Tim Ruel and Aaron Pelc.