I Bought Bitcoin! Now What?

Executive Summary:

- Virtual, or crypto, currencies are alluring for those investors willing to assume substantial risk, driven by the questionable belief that it is a viable alternative to fiat currencies and a store of value.
- The marketplace has become crowded with cryptocurrencies, with Bitcoin the most well-known.
- Owning virtual currencies can be more, or less, difficult to transact and track based upon the software or exchange platform used. Securely possessing that which you own, however, is daunting.
- U.S. taxpayers should not lose sight of the required tax reporting as well as the rigorous enforcement the Internal Revenue Service intends to apply.
- The following piece addresses some of the practical questions that arise about owning a virtual currency, but does not express any opinion on the ownership of virtual currencies as an investment.

What is virtual currency?

A virtual currency is a digital representation of value that functions as a medium of exchange or as a store of value. "Crypto" refers to the various encryption algorithms and other techniques that secure the digital currency. In contrast to hard or "fiat" currency, created by governments, cryptocurrency is created by individuals or non-governmental organizations. It is held within the blockchain network (networks of blocks of data that contain transaction ledgers chained together within a decentralized network) and not regulated or controlled by a centralized bank authority.

Crypto currency is created by "mining," which is the process of solving complex mathematical equations using enormous computing power. The mining process functionally serves as the audit process of the blockchain network that manages and records transactions and data. The "miners" are rewarded by the founder of a particular blockchain with a cryptocurrency, which the miners hope and expect to use as a source of value. The miners are usually individuals and raise money through the sale of the virtual currency "coins" to others in an "offering." The coins then function as a measure of the cryptocurrency.

How do you own virtual currency?

The nature of the blockchain system means that virtual currencies are recorded in a decentralized online ledger of all the transactions that have occurred. This system is viewed by many as secure, but history has shown that vulnerabilities exist with methods of access.

Access through an exchange

Cryptocurrency owners typically buy and sell their cryptocurrency through an exchange. Some exchanges provide access to just one or two currencies, others many more. There are thousands of global exchanges, most unregulated. Serious investors will transfer any cryptocurrency purchased on an exchange into a wallet, discussed below. But many exchanges also provide account services.

The exchange functions much like a familiar brokerage account, giving access to a number of different cryptocurrencies, "custodying" the cryptocurrency and maintaining accessible records. The exchange account owner accesses his exchange account through multi-factor authentication but does not need the security protocols or "keys," discussed below.

Exchanges, other than the newly public Coinbase Global, are generally owned by unregulated and uninsured individuals or business enterprises, and they can experience adverse or unexpected events. In 2019, for example, the owner of one Canadian exchange died and no one but the founder had access to the exchange's keys. Not only did the owner's family lose everything, but so, too, did the exchange account holders.

Using a wallet

Cryptocurrency owners will access a blockchain by using a platform, app or device designed for that purpose and possessing a "private key" and a "public key" (like very long passwords) that allow the owner to interact with the blockchain. Your keys are maintained in your "wallet." If, for example, you want to purchase a Tesla with Bitcoin, you will pay Tesla from your wallet. Tesla will give you its "public" key (like an address) and you will use your "private" key to authorize the transfer from your wallet. A transaction, once authorized, cannot be stopped, reversed, wiped away or in any way changed.

There are different types of wallets:

- Owners seeking the greatest degree of security will use a "hardware" wallet — a physical device like a thumb drive — that stores the information about your keys. The hardware wallet is connected to a computer or phone only when it is being used; otherwise it is stored in a secure place. But as with any physical asset, there is substantial risk of fire, flood and theft. Physical or "hard" keys can also be lost or destroyed and the information on them cannot be recovered.
- "Soft" wallets, also called "hot wallets," run on an app that can be installed on a PC, laptop or phone. They may or may not be hosted by a well-known exchange such as Coinbase, eToro or Robinhood. The keys are generated through the software and may be vulnerable to hacking as the app is always on the internet-connected device. Individuals may have both types of wallets, keeping a small amount on the soft wallet for purchases and more frequent transactions. There are numerous anecdotes about lost hard wallets and malfunctioning or lost hard drives, laptops or phones for soft wallets, all of which ultimately end with substantial loss.

To summarize, owners' wallets are generally not regulated, insured or protected. In addition to the risks of owning cryptocurrency as an investment, cryptocurrency exchanges come with significant associated potential hacking risks and the risk of failure or bankruptcy of the platform.

Why not a bank or trust company?

The unregulated market creates opportunities for bad actors to operate with few safeguards. Only one exchange, Coinbase Global, is subject to the regulation and disclosure required by the Securities and Exchange Commission.

In the investment world, privately held companies offer a partner or owner access to critical information, but that information is not available from the exchanges or cryptocurrency networks to cryptocurrency users. The cryptocurrency market has little transparency or regulation. For this reason and because of the digital hacking risks, no U.S. bank or trust company has yet created a platform for its clients to custody virtual currency at the bank in any way other than through a mutual fund.

Are virtual currencies private?

All transactions in cryptocurrencies are stored publicly and permanently on the blockchain. The ownership of the cryptocurrency in the blockchain is private, identifiable only through the keys. This information is secure because of the technology involved and the extraordinary resources required to hack a private key.

However, cryptocurrencies are most often bought and sold on exchanges, and the exchanges, like any other software platform, can be manipulated and hacked. Authorities can trace your identity through your wallet registration in a number of ways, although individuals and organizations pursuing criminal activities are always looking for ways to avoid detection. Exchanges like CoinBase regularly report ownership interests and transactions to the IRS. The IRS has even issued "John Doe" warrants to platforms and apps to allow the IRS to identify owners and verify they are reporting their taxable transactions.

Am I taxed on my cryptocurrency transactions?

U.S. citizens are taxed on cryptocurrency in the same manner as they are taxed on any property held for investment. Individuals who "mine" or create cryptocurrency pay ordinary income tax on the value of the "coins" they receive for mining.

If you are paid by your employer in cryptocurrency, as some star athletes are now demanding, it is taxed no differently than receiving compensation measured in U.S. dollars.

When an individual purchases cryptocurrency, the purchased quantity has a cost basis, just as a security would. Similarly, the same currency purchased at a different time will have a separate basis, or lot. When cryptocurrency is sold, traded, converted or used to purchase goods and services, the owner will identify the lot being sold or used and realize gain or loss based upon the value of the cryptocurrency in U.S. dollars. Also, like most other assets, short- and long-term gains reference a holding period less than or greater than one year. You will receive a Form 1099-K (Payment Card and Third Party Network Transactions) from your cryptocurrency platform or app if you had more than 200 transactions with an aggregate value of more than $20,000 in the last year, but that only gives you information about the cryptocurrency you sold or used. You are responsible for keeping the cost basis and computing your gains and losses for every transaction.

TAX CONSIDERATIONS FOR CRYPTOCURRENCY

- Keep track of your cost basis by tax lots
- Identify which lots you sell, trade or use to purchase goods and services
- Report short- and long-term gain/loss transactions with your securities sales on your personal income tax return
- Respond to the cryptocurrency question on your Form 1040
- Be aware the IRS is watching
- Take special care with reporting if your wallet is with a non-U.S. platform

In December 2020, the U.S. Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), indicated its ever-heightening interest in enforcing the tax regulations and attacking money laundering by issuing a notice discussing foreign cryptocurrency accounts. These accounts may include any virtual currency traded on a non-U.S. exchange or perhaps even issued by a non-U.S. situs blockchain parent. We do not have regulations yet, but we do know they are forthcoming and will require U.S. persons to report these assets to Treasury and FinCEN, just as foreign bank accounts are reported on a Form 114 (formerly called an FBAR). Failure to file a required Form 114 can garner penalties of more than 50% of the value of the asset.

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Incorporating cryptocurrency into your estate plan

In theory, digital assets should be treated no differently than other assets by your personal representative, executor or trustee. However, most digital assets – from airline miles to a Facebook account to cryptocurrency – require passwords to access them. And some digital platforms have "Terms of Service" that prohibit anyone other than the living owner from accessing them easily.

Cryptocurrency presents special problems because you do not have the usual physical indicia of ownership. Do not leave it to your heirs to guess whether you owned cryptocurrency. Be sure to make its existence known to your family, attorney or other trusted advisor. Of highest importance is protecting and storing the private keys for a soft wallet not connected to an exchange or the physical thumb-drive-like piece that is required for a hardware wallet. A safe deposit box is a common place for storage. One might also include instructions on how access will work.

Cryptocurrency custodied on an exchange does not require these special security steps but may be subject to multi-factor authentication, which needs to be accessible to the executor. Digital access laws are being passed in most states that set the rules for how and when executors and others can access the accounts of a deceased person, but these laws may not solve the problem of requiring a private key for cryptocurrency.

In all cases, the owner should keep detailed cost basis for the cryptocurrency. The person to whom you give your financial power of attorney if you are disabled and your executor will need these records for tax reporting.

Conclusion

Cryptocurrencies present risk from an investment, security and transactional perspective. The lack of regulation enhances the risk, inviting bad actors into the arena and making many areas of operation opaque. Investors should pay careful attention to tax reporting requirements and seek to understand existing and future reporting.

Ardent believers in crypto assets, however, believe this is the future, with the vulnerabilities of this emerging ecosystem typical of emerging paradigm shifts, and that with constant experimentation, refinement and improvement, a secure reality will emerge. The recent issuance of digital currency by China's Central Bank suggests that sovereign governments understand the power of cryptocurrency and are harnessing the technology to maintain control of their fiat currencies. Once that occurs in earnest, it would not augur well for private cryptocurrencies. China banned initial coin offerings in 2017, and India is seriously considering curtailing cryptocurrencies as well.

In the meantime, as digital currencies evolve, this article is designed to alert you to the risks, vulnerabilities and pitfalls in participating in this asset class, and alert you to steps you should affirmatively take should you choose to participate.

To learn more, reach out to your Relationship Manager or visit our website.