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Cryptocurrency Tax Rules

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Since the inception of Bitcoin ten years ago, the number and availability of cryptocurrencies has expanded greatly. Over the following decade since the first Bitcoin was mined, cryptocurrencies would see a dramatic rise in distribution and price. By 2017, the price of many cryptocurrencies had grown by more than 1,000%!

But in 2018, cryptocurrencies experienced a disastrous selloff, and many of the cryptocurrencies would see losses of almost 80% of their value. Investors who sustained sizeable losses began to seek advice about what to do with realized and unrealized losses from a tax planning and reporting perspective.

Fortunately, the IRS issued Notice 2014-21 in March of 2014 to provide guidance. The format of the notice was in the form of sixteen "Frequently Asked Questions." For each of the common questions regarding income tax aspects of cryptocurrency or "virtual currency", the IRS provided its answer. We will address some of the sixteen questions in this article.

Notably, the IRS stated that virtual currency is treated as property, rather than currency. While the difference in terminology is subtle, this has a meaningful impact on the tax treatment of gains and losses realized on sale or exchange of the virtual currency. Take an example of a U.S. person whose functional currency is the US dollar. If that person buys a foreign currency, say Mexican pesos with his US dollars, any gain or loss experienced by the purchaser of the pesos on disposition is treated as foreign currency gain or loss taxable as ordinary income or loss under specific Internal Revenue Code provisions.

Property, on the other hand, is treated as a capital asset. Therefore any realized gains or losses on sale or exchange of property will result in capital gain or loss.

Obviously, capital gains have preferential lower tax rates if the exchanged property was held more than one year. On the negative side, capital losses can only offset capital gains for individuals, and up to $3,000 of ordinary income with any excess losses in any tax year. Any unused capital losses carry forward indefinitely for use in future years until the losses are fully utilized. Any remaining capital loss carryforwards will expire at the death of the taxpayer who owns them.

A virtual currency can also be used as payment for goods or services. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received. The basis of virtual currency that a taxpayer receives as payment for goods or services is the fair market value of the virtual currency in U.S. dollars as of the date of receipt. For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt.

But what if you exchange appreciated virtual currency to acquire other property? If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.

If you happen to be paid for performing services in a virtual currency, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, Wage and Tax Statement. Likewise, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.

So pay attention when transacting with virtual currencies. Now that the IRS has issued this guidance, failure to follow it will result in the imposition of accuracy related penalties!

Perspective

Strength

U.S. Tax Considerations for Non-U.S. Tax Residents

We have commented in earlier newsletters about the complexities of non-citizen U.S. tax residents complying with U.S. tax and information reporting rules. With the advent of increased tax information sharing among the countries of the world on the income and expenses from activities of those living within their borders, U.S. tax residents need to seek out competent tax counsel to steer clear of substantial penalties for noncompliance. Ignorance of the law (or willful blindness) is no excuse when it comes to dealing with the IRS.

A key characteristic of the U.S. system of income taxation is that our rules impose income tax on U.S. citizens and residents based on their worldwide income. The U.S. is one of only two countries in the world that use this concept. Therefore, many U.S. tax residents who are familiar with less encompassing rules from their home countries of citizenship may inadvertently fall out of compliance with the U.S. rules by assuming the same rules apply here.

The first inquiry for a non U.S. citizen to make is whether you are a U.S. tax resident. To determine whether non-U.S. citizens will be treated as residents, they must meet either the Green Card Test or the Substantial Presence Test.

A foreigner meets the Green Card Test if he or she is a Lawful Permanent Resident of the United States at any time during the calendar year. He or she is a Lawful Permanent Resident of the United States, at any time, if he or she has an alien registration card, Form I-551, also known as a "green card."

A non-U.S. citizen without a Green Card can still be a resident alien if he or she meets the Substantial Presence Test. This test counts the number of days an individual has been physically present in the U.S. in the current year, and over the past 3 years. To meet the Substantial Presence Test, you must be physically present in the United States (U.S.) on at least:

31 days during the current year, and 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting: (a) + (b) + (c), where (a) All the days you were present in the current year, (b) 1/3 of the days you were present in the first year before current year, and (c) 1/6 of the days you were present in the second year before the current year. Fast forwarding to the answer of the commonly asked question, what is the minimum average number of days over the last 3 years to meet the physical presence test? Answer, 122 days. This 3 year average calculation catches many off guard who are focused on being in the U.S. less than 183 days in any particular year, focusing only on the current year and not the average of the prior 3 years.

Once you are classified as a U.S. tax resident under either the Green Card or Substantial Presence Test, U.S. taxation is virtually identical to taxation of its citizens. From our experience, the three most common ways for a foreigner to find themselves subject to U.S. income tax and information reporting is:

- Marry a U.S. citizen
- Born in the U.S. and never lived there (you have birthright citizenship)
- Inadvertently spend too many days in the U.S. during the year, or over the prior three years, and pass the substantial presence test

While U.S. tax rules may be imposing, there are mechanisms through foreign tax credits to avoid double taxing income in the U.S. and again in the country of citizenship. The net result of the credit is that the foreigner should generally pay no more tax on annual income than the higher of the rates of the U.S. or the foreigner's home country.

Getting access to U.S. tax counsel that is competent in dealing with cross border tax scenarios is imperative. Many U.S. tax residents overlook basic information reporting requirements. These reports do not impose tax, but can result in substantial civil and even criminal penalties for failure to make certain annual disclosures.

Should You Count on Social Security in Your Retirement Plans?

One of the most controversial topics in the United States today is the future of the Social Security retirement income program. The Social Security board recently said that in 2022 they will be spending more in benefits than they will be generating in revenue. And unless changes are made by 2035 the reserves will run out of money. Current and future retirees are notably concerned that the retirement income they have been promised won't be there. But before we look to the future of Social Security let's take a look at the current ways the program generates revenue to fund benefits.

There are currently three different ways that Social Security brings in revenue. The first source, the trust fund receives 6.2 percent of the first $132,000 in wages from every American worker in the form of payroll taxes from each paycheck. The employer matches the employee's contribution up to 6.2 percent. This equates to 12.4 percent of total wages earned by Americans being Contributed annually into the trust fund. This is the greatest source of revenue for the Social Security trust fund providing nearly 88% of the program's income in 2017. The other two sources of revenue are the interest earned on the reserves each year, and the income taxes paid by benefit recipients. Combined, these two sources of revenue generated 12% of the funding in 2017.

While these numbers sound promising, the problem largely lies in the changing demographics of today's population. When Social Security was created the number of people that could benefit from the program was much smaller due to the population's life expectancy and number of retirees. But with Baby Boomers beginning to retire, and people living longer, the ratio of workers paying into the trust fund compared to the number of retirees is greatly decreasing. This is where the problem lies, and backs the Board of Social Security's claim that the trust fund will run dry in sixteen years by 2034 if changes are not made.

Despite this stark outlook, we do have a long time to make 12.4 percent of total wages earned by Americans being contributed annually into the trust fund. This is the adjustments to the program to lengthen its sustainability. Some of the changes being considered are:

1. **Increase the age of full retirement for younger workers.** This is probably one of the most obvious changes to be made due to the fact people are simply living longer than they were when the last changes in the Full Retirement Age were made. People may simply need or want to work longer, and in theory save more money for retirement.

2. **Increase the percentage taxed on wages to pay for Social Security.** No one likes to be taxed more, but one of the changes purposed to keep the program afloat is to increase the taxes now rather than later. Congress is currently proposing a gradual increase from 6.2% to 7.2% of payroll taxes being paid to the program. This increase in taxes is said to cover the program well into the next century.

3. **Decrease the current or future planned benefits.** As a last resort, there may be a need to decrease the percentage of benefits people can expect from their Social Security checks.

From our perspective, it is premature to conclude that the Social Security trust fund will inevitably go bankrupt. There are certainly issues, but you should look at your long term planning as though your Social Security retirement income is going to be there for you. The great unknown is how much or when it may be available to you. We believe that Social Security should be considered in your financial plan. However, a good retirement plan will emphasize the need to acquire multiple sources of retirement income so that no single source can determine the success or failure of your retirement plan.

Wisdom

Discipline

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Contributing to this issue:

R. Craig Brubaker

2727 N Harwood, Suite 225

Dallas, TX 75201

214-855-2550

www.view-cap.com

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We seek to bring wealth planning best practices and a wide range of non-proprietary solutions to our clients. We also conduct our own research and diligence on world markets and investment alternatives.

For further information, please contact your investment representative or one of our wealth planning specialists:

R. Craig Brubaker	214-855-2556 cbrubaker@view-cap.com

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