Tax Tidbits

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What is Virtual Currency?

As virtual currency continues to rise in popularity, the IRS is doing its best to keep up with the constantly changing environment. Most people have heard of Bitcoin and are now starting to use it in everyday life. The NYC Mayor-elect said he plans to take his first three paychecks in Bitcoin and wants NYC to be the center of the cryptocurrency industry. Times are changing and it is important to know what virtual currency is and how transactions are taxed.

Bitcoin is a type of unregulated digital currency called cryptocurrency. A central bank does not issue this type of currency; therefore, it is not subject to any monetary policy. Cryptocurrencies depend on a shared database that is managed by a global network of computers, also known as a blockchain network. Under current law, crypto exchanges are not required to report to the IRS losses and gains realized by their customers through the purchase and sale of digital assets. Taxpayers, however, are required to report these sales on their income tax return. Proposed legislation would require new reporting requirements for the crypto brokers or centralized exchanges.

The sale of virtual currencies generally has tax consequences that could result in a tax liability. You must recognize any capital gain or loss on the sale, subject to any limitations on the deductibility of capital losses. Other transactions that trigger capital gains are an exchange of one virtual currency for another or using cryptocurrency or crypto debit cards to pay a merchant. Dispositions of virtual currency through a sale, exchange or payment to a merchant will need to be reported on Form 8949 Sales and Other Dispositions of Capital Assets. Not all transactions are taxable. If you are buying cryptocurrency and holding it, you would not have a taxable event. The same goes for transferring cryptocurrencies between exchanges or wallets.

In addition to a proposed reporting requirement, there is another proposal to add commodities, currencies and digital assets to the wash sale rule. A wash sale occurs when you sell a security at a loss and then purchase that same security or a "substantially identical" security within 30 days. Your loss will be disallowed and added to the cost basis of the securities you repurchased. Currently, the Internal Revenue Service classifies cryptocurrency as property, rather than a security. Investors in virtual currency are not subject to the wash sale rule and can quickly sell and buy the currencies while still claiming the deduction. This proposal would close that loophole.

Other transactions from virtual currency may be considered ordinary income and not capital gains. Some taxpayers are mining cryptocurrency. In simple terms, mining involves the use of high-powered computers to verify various forms of cryptocurrency and adding transaction records to a blockchain. Taxpayers earn cryptocurrency for processing these transactions, similar to the fees a merchant pays a credit card processor. If you are in the business of mining or as a personal investment, you must report the mined cryptocurrency as ordinary income. The difference is how the income is taxed. If you are in the business of mining, you need to file a business return and you can deduct ordinary and necessary expenses. You may be subjected to self-employment taxes. If you treat the activity as a personal investment, you report your income as other income. Expenses, however, are not allowed and you would pay tax on your entire cryptocurrency income.

More businesses are accepting cryptocurrency, such as Bitcoin, for payment of goods or services. Those businesses would report receipt of the cryptocurrency as income on their business return. Since the fair market value (FMV) of virtual currency changes, you will need to keep track of the fair market value of the virtual currency when it was received. The FMV when received would be the amount of income reported on your tax return. For example, if the FMV of the currency when received was $1,000 and then decreased to $500 by the end of the day, the income reported is still $1,000. If you use that same virtual currency (FMV of $500) to pay a vendor, the current fair market value when you transferred the payment to the vendor would be the total amount of your expense reported on your tax return. Additionally, you would need to report the disposition of the virtual currency on Form 8949. In this situation, you would report a loss. The cryptocurrency was "sold" for $500 and your basis was $1,000. Using cryptocurrency in your business will create additional

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Tax Policy Game Show in Washington

For those of you who have followed the majority party's attempts of enacting and funding its "social infrastructure" bill, which used to be called welfare spending, it would seem like you were watching a game show where contestants have to keep changing their answer until they come up with the correct combination to win.

Originally, the majority party had hoped to increase the tax on capital gains and dividends on those who make over $400,000 per year to the highest levels seen since the 1970s and 1980s, while increasing the corporate tax to 28%. Also included in the plan was a provision for the IRS to snoop through every American's bank account transactions without a warrant as long as the account had more than $600 of transactions per year.

Two Democratic Senators, Joe Manchin and Kyrsten Sinema, have stood up against this plan, which could doom the entire bill. The leadership then proposed a "billionaire's tax" that would tax unrealized capital gains for the first time. This so-called tax would have problems on how to value private assets that do not trade like stocks, what to do when a billionaire loses money in a particular year and what happens if someone loses enough money that they are no longer a billionaire, but still are worth $999 million. The corporate tax rate would also be raised to only 25%.

This still would not be good enough to make a deal. Currently, the billionaire's tax, increased capital gains tax and permission to snoop through bank accounts are on the back burner. The new proposal would create a 15% minimum corporate tax that companies with over $1 billion in profits would have to pay, limiting some deduction use. This, combined with higher and expanded tobacco and vaping taxes and coupled with more money for aggressive IRS enforcement of current tax law would fund their new welfare program. A possible wild card would be a two-year shift of the cap on state and local tax deductions, which are currently capped at $10,000 per year. The proposal is a gimmick to remove the cap for two years by adding it to two years in the future.

Funny thing is that no one mentions a tax on "carried interest." Carried interest is how certain investment managers get compensated by making private equity or venture capital investments, but get taxed at the lower capital gains rate instead of the higher wage rate. Presidents Obama and Trump both wanted this tax loophole eliminated, but a certain Senator from New York has always blocked the proposal even though it would bring in $65+billion under this bill's time horizon.

For those making under $400,000, prepare to be taxed if you are a nicotine user despite recent campaign promises. As for how this all ends, who knows since the tax proposals radically change from week to week. What is in this article is as of November 1st.

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Virtual

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challenges for recordkeeping. The good news is there is software available to help with that recordkeeping.

Another potential change is the reporting of virtual currency on the Financial Crimes Enforcement Network (FinCEN) Form 114 Report of Foreign Bank and Financial Accounts. FinCEN has announced an intention to amend the rules to require Report of Foreign Bank and Financial Accounts (FBAR) disclosures for virtual currency. United States persons are required to file a FBAR if they hold a financial interest in or signature authority over at least one financial account located outside of the United States if the aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year. The reporting obligation may exist even if there is no associated taxable income. If you fail to file the FBAR, the penalty is up to $10,000 per violation for non-willful violations and up to $100,000 or 50% of the balance in the account for willful violations.

It is important to understand the tax consequences of dealing with virtual currency, which has been around for many years. Legislation is now catching up to ensure proper reporting of virtual currency transactions on tax returns.

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Child Tax Credit

There have been important changes to the Child Tax Credit that will help many families receive advance payments from the IRS. Advance Child Tax Credit payments are early payments of up to 50% of the estimated amount of the Child Tax Credit that you may claim on your 2021 tax return. You qualify for advance Child Tax Credit payments if you have a qualifying child. Also, you or your spouse, if married filing a joint return, must have your primary residence in one of the 50 states or the District of Columbia for more than half the year. You do not have to have income, a job or a permanent address to be eligible for advance payments.

The IRS estimates your 2021 Child Tax Credit based on information from your processed 2020 tax return. If the IRS has not processed your 2020 tax return when they determine your advance Child Tax Credit payment amount, the IRS will use information shown on your 2019 tax return or information you entered in the Non-Filer tool on IRS.gov in 2020.

For tax year 2021, qualifying families claiming the Child Tax Credit will receive up to $3,000 per qualifying child between the ages of 6 and 17 at the end of 2021 or up to $3,600 per qualifying child under age 6 at the end of 2021. This means that eligible families can receive advance payments of up to $300 per month for each child under age 6 and up to $250 per month for each child age 6 and above. The maximum credit is available to taxpayers with a modified adjusted gross income of $75,000 or less for single filers and married persons filing separate returns, $112,500 or less for heads of household and $150,000 or less for married couples filing a joint return and qualifying widows and widowers.

The IRS will issue advance Child Tax Credit payments July through December 2021. If the IRS has received your banking information, your payment will be sent to you as a direct deposit. If the bank account information is not on file, the IRS will send your advance Child Tax Credit payments by mail. The Child Tax Credit Update Portal on the IRS website allows people to un-enroll from advance payments. Some families may prefer to wait until the end of the year and receive the entire credit as a refund when they file their 2021 return. The un-enroll feature can also be helpful to any family that no longer qualifies for the Child Tax Credit or believes they will not qualify when they file their 2021 return. This could happen if, for example, your income in 2021 is too high to qualify you for the credit, someone else (an ex-spouse or another family member, for example) qualifies to claim your child or children as dependents in 2021 or your main home was outside of the United States for more than half of 2021.

When you file your 2021 tax return, you will need to compare the total amount of the advance Child Tax Credit payments that you received with the amount of the Child Tax Credit that you can properly claim on your tax return. If the amount of your Child Tax Credit exceeds the total amount of your advance payments, you can claim the remaining amount of your credit on your tax return. If you receive a total amount of advance payments that exceeds the amount of Child Tax Credit that you can properly claim on your tax return, you may need to repay the IRS some or all of that excess payment. In January 2022, the IRS will send Letter 6419 to provide the total amount of advance payments that were disbursed to you. Keep this letter regarding your advance Child Tax Credit payments with your tax records. You may need to refer to this letter when you file your 2021 tax return.

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New 1099-K Reporting

Beginning January 1, 2022, the new Form 1099-K reporting requirements go into effect. Under the current law, a Form 1099-K would need to be filed by a payment settlement entity (PSE) if payments to a recipient total more than $20,000 and there are more than 200 transactions annually. If you have less than $20,000 in payments and 200 transactions, the IRS will have no report of the payments. As a result, many payments go unreported on the tax return by the taxpayer.

Under the new rules, Form 1099-K will have to be filed by a payment settlement entity if a recipient is paid $600 or more during the year for goods or services, with no minimum number of transactions requirement. This means even a single transaction for $600 or more will require a Form 1099-K to be issued. Payment settlement entities include payment apps such as Venmo, Zelle and PayPal. Additionally, this applies to anyone who sells goods through sites such as Etsy, EBay or Facebook Marketplace.

If you receive a Form1099-K, where is the activity reported? It depends if the activity is a business or a hobby. The IRS has nine factors to determine if you are operating as a business. If the activity does meet enough factors in the 9-factor test, then it will go to its own business schedule, such as a Schedule C and all business related expenses become deductible. If the activity does not rise to a business level, it is a hobby. Hobby income is still reported as other income on Schedule 1 of the 1040, but expense deductions are limited to cost of goods sold and to the dollar amount of income.

Some taxpayers use payment apps like Venmo to transfer money to other individuals for different reasons. Not all transfers are taxable income. For example, if you pay for a vacation rental and receive a Venmo payment from a friend for their share of the expense, you would not include that payment as income on your tax return.

With the new reporting requirements, we will see more Form 1099-Ks issued than ever before. If you receive a Form 1099-K, do not ignore it. The IRS has document matching and if it is not reported on your tax return, most likely you will receive a tax notice.

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Backdoor Roth and Mega Backdoor Roth

In September 2021, The House Ways and Means Committee passed $2.1 trillion in tax hikes that will help fund President Joe Biden's American Families Plan. Among their proposals are the elimination of backdoor Roth and mega backdoor Roth conversions. Both of these could affect you if you earn too much to contribute to a Roth IRA and you want to increase your Roth account balances.

Backdoor Roth – a strategy for people whose income is too high to be eligible for regular Roth IRA contributions. You simply roll money from a traditional IRA to a Roth. There are no income or contribution limits; however, you risk a hefty tax bill on the rollover if you have pretax money, contributions you've deducted or investment earnings sitting in any traditional IRAs, thanks to the IRS' pro-rata rule.

Mega Backdoor Roth – for people who have a 401(k) plan at work in which they can put up to $38,500 of post-tax dollars into their 401(k) plan and then roll it into a mega backdoor Roth.

If executed properly, the backdoor Roth and mega backdoor Roth strategies involve very little in tax outlays, but have the potential to result in significant tax savings for investors who hold them for the long haul. That is likely what put them in the sights of Congress – they bring in little revenue for the government and also reduce future tax receipts.

If you make above the income limit for a Roth IRA contribution, you can make an after-tax contribution to a traditional IRA and immediately convert it to a Roth. The Roth IRA income limits for 2021 are $140,000 for individuals and $208,000 for married couples. Those individuals are also well above the income limits for taking a deduction for IRA contributions. There are different rules for each retirement account, so please consult your tax preparer to see which plan would be most beneficial.

Congress is looking for ways to raise taxes on the wealthy in order to fund government spending. While these changes won't produce an immediate boost to tax revenue, they could provide future governments with more money, as retirement savers are forced to put more of their savings in taxable investment accounts. Congress views the backdoor Roth and the mega backdoor Roth as ways for wealthy individuals to avoid paying their fair share in taxes. You have to make a certain level of income in order to afford to contribute more than the maximum tax-advantaged contribution to a 401(k).

Of course, the proposal is just that, a proposal, and it will need to pass through a deeply divided Congress before it becomes law. It may be tempting to ignore the whole thing until there is something final. If the proposal becomes law, it will be quite time-sensitive. There are better tax advantages by investing in a regular brokerage account than keeping after-tax funds in a traditional IRA, not to mention the additional flexibility of keeping investments outside of a retirement account. Creating a mega backdoor Roth is complicated, with many moving parts and the potential to get hit with unexpected tax bills, so consult your financial advisor or tax preparer.

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Please note that our Tax and Business Services Department, our Insurance Division and our Investment Advisors are available to answer any questions that you may have regarding the articles in this publication. We look forward to hearing from you.