NEWS YOU CAN USE FROM ANDERSEN

for the Record

Cryptocurrency: Recognizing Tax Consequences and Planning Accordingly

Despite the recent volatility and uncertainties surrounding cryptocurrency such as Bitcoin, it continues to gain worldwide attention.

The draw of cryptocurrency includes simplifying international currency changes, reducing transaction fees, and providing a means for the instant transfer of funds. Crypto can also be used as an investment asset or as a form of electronic payment for goods and services. However, it is also important to recognize that relying on cryptocurrency for financial planning is not for the faint of heart. The disadvantages of crypto include a frequently (and sometimes wildly) fluctuating value, an uncertain regulatory outlook in nations across the world, concerns over the environmental impact due to some cryptocurrency's heavy demand on energy for mining transactions, and potential association with criminal activity. This article sets forth the U.S. tax guidance and opportunities that cryptocurrency offers to those brave enough to wade in these waters.

Current Guidance

Although the popularity of cryptocurrency with investors continues to grow, formal tax guidance from IRS remains fairly limited. The most significant guidance issued to date came in the form of Notice 2014-21, which was subsequently adapted as an FAQs page regarding virtual currency on IRS's website. Despite the fact that taxpayers may use Bitcoin (and other cryptocurrencies) to pay for goods and services as one would with fiat money, Notice 2014-21 does not treat virtual currencies as currency for federal income tax purposes. Rather, Notice 2014-21 expressly states that virtual currency is treated as property for federal income tax purposes, subjecting it to the rules of Subchapter O commonly applied to capital assets.

transactions involving virtual currency. Similar to any other property purchase, acquiring virtual currency with fiat money creates basis in the virtual currency in the amount paid. If virtual currency is received in exchange for other property or services, basis in the virtual currency equals the value of the property exchanged or services performed. When virtual currency is sold or exchanged, capital gain or loss must be recognized based on the value of the property, services, or currency received in exchange for the virtual currency. Depending on the holding period of the virtual currency, the capital gain will be taxed at either the short, or long-term rate.

Please click on the link below for a table showing the tax consequences and character with respect to some of the most common cryptocurrency transactions.:

Tax Consequences & Character – Common Cryptocurrency Transactions

Planning Opportunities

As it pertains to estate planning, the inherent volatility of cryptocurrency provides significant opportunity for taxpayers that subscribe to the “high-risk, high-reward” mindset. During this year where cryptocurrency values are depressed relative to 2021 levels, estate-freeze techniques such as Grantor Retained Annuity Trusts (i.e., GRATs) could be attractive to those bullish on cryptocurrency in the short and mid-terms (even amidst a steady rise in interest rates). Since GRATs can be structured such that the transfer to the trust uses little to no gift-tax exemption, GRATs are also a good hedge transaction against cryptocurrency volatility.

On the income tax side, special care should be taken first to properly record all cryptocurrency-related transactions. As the above table illustrates, most transactions involving cryptocurrency generate a taxable event, including those that may not seem taxable on their face (e.g., using cryptocurrency to purchase other currencies, NFTs, or any other good or service). Cryptocurrency provides a unique opportunity for further tax savings by allowing its user to conduct capital loss harvesting to offset against other capital gains while maintaining their exposure to the cryptocurrency. Unlike traditional securities, cryptocurrency is not subjected to Sec. 1091, commonly referred to as the “wash sale” rules, which disallow the recognition of capital losses of a security if the same or substantially similar security is purchased 30 days before or 30 days after the date of disposition. Taxpayers who bought at the peak of cryptocurrency values, which may now be significantly depressed, can immediately sell their coins and tokens for a capital loss, and immediately repurchase the same coins and tokens and reset their cost basis.

One other attractive income tax planning idea for owners of highly appreciated, long-term cryptocurrency is to use it charitably. Many public charities and donor-advised funds now accept cryptocurrencies, so a charitable contribution of cryptocurrency could service both income tax planning and charitable endeavors. Given the ridged and complicated valuation substantiation requirements relating to charitable contributions, it is critical that individuals looking to make charitable contributions of cryptocurrency consult their tax advisor before any donations.

The Takeaway

Cryptocurrency remains a prevalent aspect of capital markets in an increasingly digital world. Taxpayers and tax advisors should be aware of the current state of cryptocurrency taxation but be cautioned that it is a topic that is both in flux and remains squarely on IRS's radar. The tax law surrounding cryptocurrency will continue to develop and tax planners should be prepared to react accordingly.

Andersen Tax LLC | 333 Bush Street, Suite 1700, San Francisco, CA 94104

NEWS YOU CAN USE FROM ANDERSEN

for the Record

Navigating the Tax Implications of the Russia-Ukraine War

As the war between Russia and Ukraine rages on, the conflict continues to cause widespread disruption to global supply chains and increased inflationary pressure. Along with this disruption, the war is also generating important tax implications for both individuals and businesses. A few of the tax issues that have arisen in connection with the Russia-Ukraine war include tax losses, overseas charitable giving, and workforce global mobility.

Below are highlights of a few of the tax implications that have arisen in connection with the Russia-Ukraine war. It is critical that the full impact of the conflict be analyzed and that issues are identified to manage the ongoing consequences of the war on taxpayers.

Tax Losses Related to the Russia-Ukraine War

Russia's invasion of Ukraine was met with heavy sanctions, strategic boycotts and financial countermeasures. While the actions were aimed at addressing an immediate danger in a discrete geographic area, they have also had a ripple effect that impacts taxpayers globally. Among the potential impacts are physical loss of assets as well as losses caused by issues with supply chains, contracts, intangibles and investments. Losses sustained for business or investment property under war conditions are deemed casualties under the Sec. 165 loss rules. Losses that stem directly from the response to the Russian invasion in Ukraine would also likely qualify as casualty losses.

These losses may be deducted on the taxpayer's federal tax return for the year the loss occurred. To substantiate these deductions, taxpayers should document the losses contemporaneously. If the loss is large, there may be an opportunity to generate an NOL, which may be carried forward indefinitely. The determination of whether a taxpayer qualifies for a casualty loss as a result of the Russia-Ukraine war and the amount that can be claimed on a return requires both tax and valuation expertise.

Read More

Charitable Contributions Supporting Ukraine Relief Efforts

As global awareness of the Russia-Ukraine war continues to rise and the effects of the conflict hit closer to home, philanthropic goals beyond U.S. borders also continue to grow. As a result, many U.S. taxpayers are seeking ways to achieve tax-efficient overseas charitable giving. Although giving overseas is often less straightforward than giving domestically, there are several structures and procedures that can be implemented to meet these goals.

Based on a theory that contributions to domestic charities relieve the government from services it would otherwise have to provide, since 1938 charitable deductions are only available when giving to U.S.-based charities. Since that time, U.S. taxpayers have looked for other ways to deduct foreign charitable contributions. This often requires the use of a U.S.-based charity intermediary and navigating the complicated rules of oversees giving.

Charity may begin at home, as the expression goes, but as recent events have shown it certainly does not end there. For U.S. taxpayers wanting to use their resources to make a positive impact in Ukraine, or anywhere overseas, there are several different methods available to achieve these goals and do it in a tax-efficient manner.

Read More

Impact on Workforce Global Mobility

The Russia-Ukraine war is impacting individuals and companies around the world. Some are helping with war relief efforts, such as assisting with evacuations, and nearly everyone connected to the region is experiencing the negative financial impact. The threat to personal safety is forcing individuals and companies to immediately relocate across borders. Emergency situations such as this give no more than minimal time to consider the global tax implications and compliance obligations. When personal safety is at issue, tax issues are, rightly so, more an afterthought.

Employers are uniquely impacted. Company operations may have been required to cease in certain locations, employees may have relocated on an indefinite basis, employers may have provided monetary relief directly to employees or via charities, etc. Employers may not know if, when or where employees have relocated. Relocations may be temporary or indefinite, with many in a wait-and-see situation. Individuals may be entitled to remain in their new locations for a limited period of time, requiring them to consider where they may relocate next. In addition, employers and individuals will also need to consider the legal restrictions as to whether they are entitled to work in a particular new location or not. This situation raises a multitude of tax questions for employers and employees alike.

These issues that are likely to arise due to displaced employees require that a strategy be developed for employers and employees to meet potential obligations.

Read More

The Takeaway

Russia's invasion of Ukraine has widespread implications for businesses and individuals. Not only has the war created a global humanitarian crisis, but it has exacerbated the financial and economic turmoil initiated by the COVID-19 pandemic. The impacts of the pandemic and the war will be felt for many years to come. Despite this crisis, the current situation also provides certain tax planning planning possibilities, as well as tax uncertainties, that should be addressed.
it to the rules of Subchapter O commonly applied to capital assets.

Andersen Tax LLC | 333 Bush Street, Suite 1700, San Francisco, CA 94104

NEWS YOU CAN USE FROM ANDERSEN.

for the Record

Research and Experimental Expenditures: Complying With New Section 174 Mandatory Capitalization Requirements

The Tax Cuts and Jobs Act of 2017 (TCJA) resulted in significant changes to the treatment of research and experimental (R&E) expenditures under Internal Revenue Code Sec. 174 that will require substantial work for many companies to implement during 2022. While this was a known change was coming, many taxpayers continued to hope that the mandatory capitalization would be repealed or postponed.

The Build Back Better Act (BBBA) included a provision to defer the effective date of these amendments, but the BBBA was stalled at the end of 2021 and is unlikely to be revived. Although there continues to be bipartisan support for legislation deferring the effective date until 2026, the timing for potential enactment is unclear, and the outcome is uncertain. As 2022 progresses, it becomes less likely that we'll see this required legislation before year end.

What Has Changed?

For tax years beginning before January 1, 2022, taxpayers could deduct R&E expenses in the year incurred. However, due to changes made by the TCJA, an immediate deduction is no longer available. Instead, taxpayers must capitalize R&E costs over five years for research conducted within the United States or 15 years for research conducted outside the United States. Both amortization periods employ a half-year convention, meaning the costs are amortized beginning with the midpoint of the tax year in which the expenses are paid or incurred. In addition, taxpayers may no longer write-off abandoned R&E. Instead, these costs continue to amortize over the preset useful life.

Section 174 defines R&E expenses as costs connected to an active trade or business that were paid or incurred to eliminate uncertainty when performing new or improved product development. Under Sec. 174, the definition of R&E eligible expenses is broader than expenses that may be considered qualified research expenses (QRE) under Sec. 41, as R&E under Sec. 174 includes all costs incident to the research and development and provides little guidance on how "incident" shall be defined. The amendments include updates to the definition of R&E by including all amounts paid or incurred in connection with the development of any software as R&E expenditures, which will impact most taxpayers. This update means taxpayers developing software may no longer rely on immediate expensing under Rev. Proc. 2000-50.

Complying With the New Sec. 174 Rules Starting in 2022

Complying with these amendments requires careful consideration and planning. Before 2022, taxpayers may not have characterized all applicable R&E costs as Sec. 174 because the tax implications in categorizing expenses as Sec. 162 ordinary and necessary business expenses or as Sec. 174 R&E expenses were the same. The new Sec. 174 requires diligent characterization of expenses between these two categories of costs. It is also essential to identify the location of the R&E activities (within the United States versus outside of the United States) because of the different amortization periods.

Some taxpayers may be able to leverage existing systems/tracking to identify Sec. 174 costs. For instance, taxpayers may have the option of using qualified research expense (QRE) used to compute the R&D credit under Sec. 41 or ASC 730 "book" research and development (R&D) expense as an appropriate starting point to compute Sec. 174 costs. The QRE approach requires several steps to adjust QREs since R&E eligible expenses are broader than those eligible as QREs under Sec. 41. The ASC 730 approach will likely require the identification of additional Sec. 174 costs not captured in book R&D expense.

Taxpayers that do not currently identify any R&E expenditures need to consider what steps are necessary to categorize expenses between Sec. 174 and non-Sec. 174 amounts. For instance, taxpayers can start tracking expenses using R&E expenditure trial balance accounts or R&E expenditure cost centers/departments to identify the capitalizable costs.

Immediate Impact

In the short term, the current Sec. 174 rules may immediately impact tax reporting requirements for a business's quarterly financial statements and estimated tax payments. The new Sec. 174 rules also can impact effective tax rates if a valuation allowance is required for the deferred tax asset or due to the indirect effects on other calculations, including the interest expense limitation under Sec. 163(j), the base erosion and anti-abuse tax (BEAT), global intangible low-taxed income (GILTI), or foreign-derived intangible income (FDII). The capitalization of the R&E may also have a significant overall impact on total tax for some companies, and the estimated payments should consider the impact of the change. The capitalization of R&E may also impact state tax liability as the requirement to capitalize R&E will likely increase federal taxable income, which is the starting point for calculating state taxable income on many state returns, except for those states that chose not to adopt the TCJA changes. Lastly, the historical interplay between Sec. 174 and Sec. 41 means that all costs considered QRE under Sec. 41 must be treated as Sec. 174 and follow the new capitalization requirements.

The Takeaway

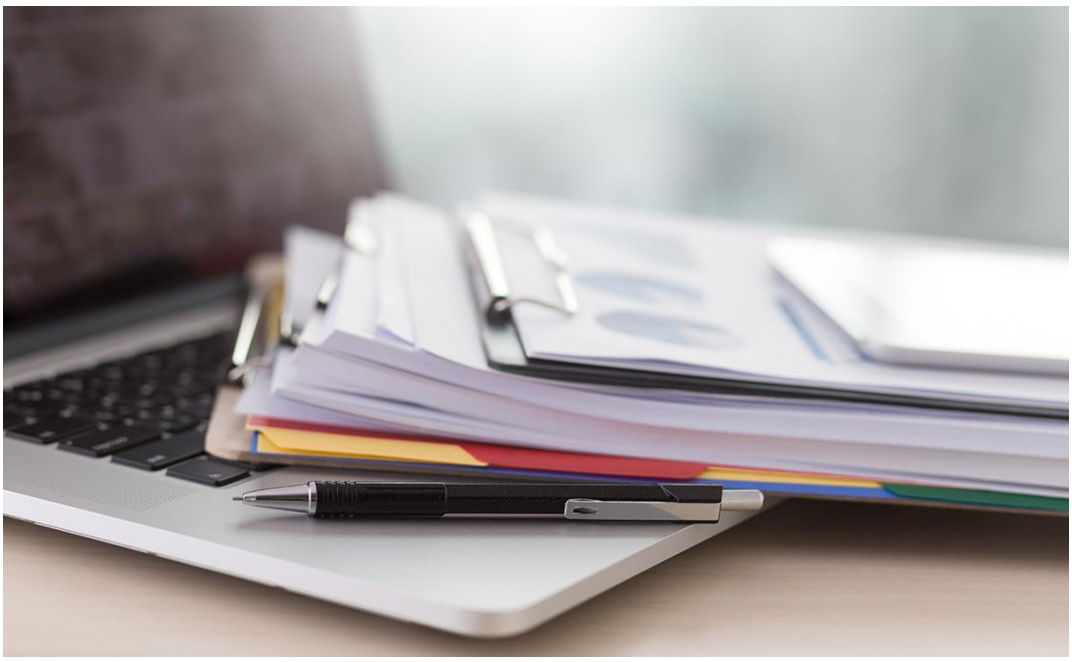
The TCJA amendments to Sec. 174 will impact a broad range of taxpayers. It remains uncertain if or when legislation will be enacted that will defer or reverse the requirement to capitalize R&E expenditures. As a result, taxpayers with significant R&E expenses should begin assessing the impact of capitalizing R&E expenditures on their 2022 taxable income for financial reporting and estimated tax payment purposes, and if material, undertake a formal Sec. 174 analysis that includes modeling the impact of these changes on the other areas of tax.

Andersen Tax LLC | 333 Bush Street, Suite 1700, San Francisco, CA 94104

NEWS YOU CAN USE FROM ANDERSEN.

for the Record

Don’t Get Burned When Selling a Partnership Interest: Hot Assets Should Be Handled With Care



Partnership interests (and interests in LLCs taxed as partnerships) are capital assets. Gain from the sale of capital assets is capital gain, which for individuals is taxed at preferential rates. Therefore, gain from the sale of a partnership interest must be taxed to individuals at the preferential rates applicable to capital gain. Although seemingly straightforward, there are exceptions. A partnership interest is a capital asset, except when it is not.

The *hot asset* recharacterization provisions of the Internal Revenue Code (IRC) frequently result in ordinary income, even though a seller may have been anticipating only capital gain. It is therefore imperative that the character of partnership assets be assessed before a sale to determine if these rules apply.

The Sale of a Partnership Interest May Trigger Ordinary Income, Not Just Capital Gain

An operating business usually consists of many different assets. Some of those assets may be capital gain property, such as goodwill or other intangibles. Some may be ordinary income property like inventory. Further still some may be a mixture of both, like equipment, which gives rise to ordinary income to the extent of the recapture of prior depreciation deductions and thereafter generally gives rise to capital gain.

If a sole proprietor sells an operating business, the seller first allocates the purchase price among the various sold assets. Based on this allocation, the seller determines its gain or loss for each sold asset by comparing the amount realized and the tax basis for each of the assets. Some of the sold assets may be ordinary income property, generating ordinary gain or loss, and some may be capital gain property, generating capital gain or loss. (Net gain from depreciable property may be treated as capital gain and net loss from depreciable property may be treated as ordinary loss, but that is a whole other issue.)

Capital losses are generally not available to offset ordinary income, and the seller could have net loss in its capital gain property and net gain in its ordinary income property. This could even happen, albeit somewhat unusually, when the seller has an overall net loss from the sale – the seller could have net capital loss in an amount exceeding the seller's net ordinary income, with the result that, even though the seller has an overall loss on the sale, the seller has an income tax liability with respect to its net ordinary income. This *phantom income* is one of the potential pitfalls associated with the sale of a partnership interest.

Partnerships are commonly described as a mixture of a separate entity and an aggregation of its partners. In many cases, a partnership is treated as an entity, calculating its own taxable income and loss, holding its own assets, determining its own tax basis, and engaging in its own activities. In other cases, a partnership is treated as if the partners of the partnership themselves undertook the activities of the partnership, held its assets or recognized its gain or loss.

In general, an interest in a partnership is subject to an entity approach, treated as a capital asset held by a partner, separate and distinct from the underlying assets of the partnership. For purposes of determining the ordinary or capital character of gain and loss from a sale of a partnership interest, however, an aggregate approach is applicable. If a partner sells its partnership interest, the partner generally determines the character of its gain or loss in a manner similar to (but not exactly the same as) that of the sole proprietor described above, separately taking into account the partner's share of gain or loss in partnership capital gain property and partnership ordinary income property.

This result is accomplished by determining the extent to which the partner would be allocated ordinary income or loss from the partnership if the partnership were to sell all of its assets for their fair market value. If the selling partner has a share of ordinary income in partnership assets of $500x, the partner generally will recognize $500x of ordinary income. If the partner recognizes overall gain of $800x from the sale, the partner will recognize $500x of ordinary income and $300x of capital gain. If the partner recognizes overall gain of $200x from the sale, the partner will recognize $500x of ordinary income and $300x of capital loss. If the partner recognizes overall loss of $100x from the sale, the partner will recognize $500x of ordinary income and $600x of capital loss.

Hot Assets Are Generally Unrealized Receivables or Inventory

What sorts of ordinary income property trigger the rule discussed above? The colloquial term for these properties is *hot assets*. As a rule of thumb, if the partnership's sale of the asset would give rise to ordinary income (or anything other than capital gain), the asset is a hot asset. In a partnership on the cash method of accounting, hot assets commonly include accounts receivable and, more generally, rights to payments for goods or services that have been, or will be, delivered or rendered. In a partnership on the accrual method of accounting, there generally is no built-in gain in these receivables, although there could be value in contracts giving the partnership the right to be paid for services or goods to be rendered or delivered in the future, and that value would need to be taken into account under these rules. An example of this kind of asset can be a valuable services contract, especially if it is non-terminable or terminable only after a significant period of time. Another example of this kind of asset is *deferred revenue*, where cash has been received by the partnership but income is not taken into account by the partnership until a subsequent tax period.

The most common source of hot asset gain is recapture of depreciation or amortization deductions from tangible and intangible property (i.e., gain from the sale of such property that is treated as ordinary income to the extent of prior depreciation or amortization deductions from that property). With respect to depreciable property, sometimes the property has no value in excess of its tax basis, so that there is no depreciation that would be recaptured if the partnership were to sell the property. However, and this is especially true with bonus depreciation, the value of tangible property may exceed

its tax basis, so that some or all of the depreciation deductions from the property would be recaptured as ordinary income if the property were sold for its fair market value. The value of intangible property generally increases, so that any amortization deductions from the intangible property are generally recaptured on a sale of the business.

The Takeaway

The Internal Revenue Service has an active campaign examining the issue of hot assets in connection with sales of partnership interests. Moreover, a partnership is now generally required to notify a selling partner of its share of hot asset gain in partnership assets. Accordingly, taxpayers and their advisors should carefully consider the issues associated with hot assets and other potential tax consequences before selling an interest in a partnership.

Andersen Tax LLC | 333 Bush Street, Suite 1700, San Francisco, CA 94104