NEWS YOU CAN USE FROM ANDERSEN TAX
for the RECORD

Asset Allocation: A Disciplined Approach in Volatile Markets

Since the Great Recession lows in 2009, U.S. equity markets have seen a nearly unprecedented run, rivaling the longest bull market in the 1990s.

As part of that run, there has also been an extended period of low volatility, enduring only five domestic equity corrections of greater than 10%. However, after almost a decade of consistent and sustained equity market growth, sharp volatility has returned, driven by trade pressures, policy changes and geopolitical concerns.

During the recessionary lows of 2009, some market experts came to believe that Modern Portfolio Theory and general buy-and-hold strategies were dead; and the only way to maintain investment performance was to strategically time trades. In periods of volatility, investor interest in market timing tends to increase as the prospect of making fast money (or cutting losses) gains appeal. However, experience and academia have shown that the ability to consistently and accurately time stock market movements is extremely difficult, if not impossible. Instead, history has demonstrated that adhering to a steady, goal-oriented asset allocation strategy will be more beneficial to investors in the long term.

Asset allocation is the process of dividing an investment portfolio among different asset categories after modeling the risk/reward of each of the categories in combination. This process seeks to provide the best possible risk-adjusted returns given an individual's time horizon, financial goals and overall risk tolerance. Put simply, asset allocation looks to invest in various asset categories and benefit from the tendency that some will zig while conceding that others may zag. A proper asset allocation allows a portfolio to withstand multiple market cycles for varying asset classes as the diversification of the portfolio assists in smoothing out overall returns during periods of volatility in a specific asset category.

Studies have shown that asset allocation can account for over 90% of the variability of portfolio returns. Meaning that portfolio returns are influenced, for better or for worse, more so by allocation decisions than by market timing or individual stock selection within each asset category.

The benefits of asset allocation only accrue when adhered to over time. To illustrate this point, from 1961 to 2015, the S&P 500 had an average annual return of 9.87%. Hypothetically, if you broke from your strategy and somehow missed the 25 best trading days for the S&P 500 during that same time period, such break would have resulted in an average annual return of only 5.74%. These best performing days often occur after some of the worst one-day selloffs in the market or prolonged corrections/recessions over a period of time. While the S&P 500 only represents one asset class, the example demonstrates the importance of being disciplined during downturns.

It is important to understand that both volatility and corrections are normal and healthy for markets. These cycles are necessary to prevent stock prices from rising to inflated levels which in turn can lead to a more severe bear market. So, in times of heightened volatility what should a disciplined investor do?

Review Your Plan

- Review both your short- and long-term portfolio goals. Ensure you have sufficient liquidity for any cash flow needs. Position your portfolio so you are not forced to liquidate assets in a period of market weakness.
- Review your portfolio time horizon. Has your timeline shifted due to certain life events? Always be cognizant of whether your long-term objectives are in line with your overall portfolio and risk allocation.
- Review your strategic asset allocation. Is it optimized based on your goals and time horizon? Rebalance your portfolio if necessary.

Stick To Your Plan

- Remove emotion from any decision making and focus on fundamentals. The worst decision an investor can make is overreacting to a short-term correction and missing the corresponding rebound. Focus on what you can control and stick to your well-developed plan.
- Use dollar-cost averaging to allocate investable cash within your asset allocation. This will not only help to potentially bolster returns during market corrections, but also help avoid the potential for inopportune market timing.
- When in doubt, do nothing and take a hands-off approach. If your portfolio is diversified and meets your time horizon, financial goals and risk tolerance, simply sit back and be confident in the well-formulated plan you have established. Do not stress yourself over short-term volatility or daily headline news that is not impactful to your longer-term forecast.

Bull and bear markets are part of investing. History has shown however that successful investors do not overreact to market runs and adjustments. Instead, these investors develop thoughtful, cohesive plans that fit their needs and stay the course over the long run.

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

Determining the Fair Market Value of Insurance Policies

A life insurance policy is an asset with many unique characteristics.

However, like most assets a value is required for an insurance policy when it is transferred in situations such as a pension distribution, a sale or gift from an individual to a trust, or in a split-dollar arrangement. Historically, while advisors have often relied on a safe harbor value for insurance policies, this method may not always be accurate and may yield results not representative of fair market value. This article focuses on the benefits associated with obtaining a fair market valuation to attain a more accurate and supportable value.

Valuation Issues and Methodologies

Often times, when a life insurance policy needs to be transferred, an advisor—unaware that a fair market valuation is a viable option—will follow IRS safe harbor guidelines and request the policy's value from the insurance company for reporting purposes. The insurance company typically provides the Interpolated Terminal Reserve (ITR). An ITR value is a value calculated from the policy's reserve value at a particular point in time. Regulations provide that this value is estimated as the difference between the policy's reserve value at the date of the last premium payment and the projected reserve value at the date of the next premium. For many types of policies and in many circumstances, ITR is not necessarily an appropriate or accurate measure of a policy's fair market value.

A fair market valuation of a life insurance policy however, will consider values based on the income approach and the market approach. The value conclusion is the greater of the results from each approach, which can be a much truer assessment of the policy's fair market value.

The income approach generally focuses on the discounted cash flows of premiums and death benefits determined by a stochastic (i.e., having a random probability distribution or pattern that may be statistically analyzed) mortality-based model. For each year the payment is the death benefit multiplied by the subject's expected mortality, less the planned premium multiplied by the subject's survival rate (Payment = (Death Benefit x Expected Mortality) – (Planned Premium x Survival Rate)). Even though individuals die at discrete events (a person only dies once and completely), a stochastic method, rather than a deterministic method, is used when projecting future mortality-based cash flows because it is impossible to predict exactly when a person will die. A life expectancy is a period of time before which an individual has a 50% chance of dying. The stochastic method is the equivalent of calculating the present value at every discrete time period (i.e., every year) then weighting the outcomes by the likelihood that each will occur.

The market approach on the other hand considers what the policy could be sold for based on the sale of similar policies. While a settlement market for life insurance policies does exist, it is very narrow and most policies would be excluded due to the age of the insured and policy type. It is therefore often more appropriate to consider the policy's liquidation value—the amount the carrier would distribute upon surrender.

The Unique Nature of Life Insurance Polices

As stated above, life insurance policies are unique assets, and asking the question, What is the fair market value of a life insurance policy?, can result in complex and inconsistent answers. Policies are illiquid assets that are regulated at the individual state level and guidance on aspects of their taxation has not been updated in over 40 years. Meanwhile, insurance policies themselves have evolved into many different forms since that time. One of the main limitations with ITR is that it is generally understood to be applicable only to whole life contracts (not necessarily to universal life, variable life, level term insurance, etc.).

ITR is most typically used to value a life insurance policy for transfer tax purposes and is provided by the issuing life insurance carrier via Form 712, Life Insurance Statement. A policy's terminal reserve is the amount of money that the life insurance carrier has set aside by law to guarantee the payment of policy benefits and is determined once a year. The ITR is a mid-year estimate of the terminal reserve value determined by adding the current year's increase to the prior year's reserve.

With the advent of non-guaranteed unbundled or deconstructed policies in the 1980s and 1990s—flexible premium adjustable life, commonly also known as universal life—different industry reserve requirements were introduced. For this type of policy, the carrier uses a different test than the test designed for whole life policies. To make things even more complicated, there are multiple reserve values tracked by insurance carriers today that were not used back when the regulations on ITR were issued. These reserves include (1) tax reserves, used to determine a carrier's federal income tax, (2) statutory reserves, required for a carrier's financial statement filed with state insurance departments, and (3) Actuarial Guideline (AG) 38 reserves, reserves required by the National Association of

Insurance Commissioners (NAIC) for all universal life policies that employ secondary guarantees, with or without shadow account funds. Guidance on ITR has never been updated to account for these newer life insurance products or multiple reserve values.

How a Valuation Can Help

Determining the fair market value of a life insurance policy can present clients with both opportunities and challenges. However, reliance on the ITR value and IRS safe harbor rules can result in tax implications that do not align with the fair market value of the policy. A qualified valuation can help provide a supportable and more accurate determination of the fair market value when transferring an insurance policy.

Andersen Tax LLC. | 100 First Street, Suite 1600, San Francisco, CA 94105

NEWS YOU CAN USE FROM ANDERSEN TAX
for the RECORD

Qualified Small Business Stock – Navigating Potential Traps and Ways Around Them

The Qualified Small Business Stock (QSBS) exemption is an often misunderstood and under-utilized gem in the tax law.

Essentially, if a taxpayer sells QSBS, up to 100% of the gain can be excluded from federal (and sometimes state) income taxation. Because of the misconceptions often associated with QSBS, even when business owners are aware of the exclusion, they or their company may take actions that, while seemingly benign, unintentionally disqualify the stock from QSBS treatment. This article will explore a few potential traps and make some suggestions to avoid those traps.

The S Corporation Trap

Only investments made directly in a domestic C corporation will qualify for QSBS treatment. Therefore, any original investment in a corporation that was an S corporation at the time of the investment will not qualify for QSBS treatment. The following examples illustrate this potential trap:

- Taxpayer forms and funds a Delaware corporation on February 1st. She is then advised that in order to claim the company's start-up research and development (R&D) losses on her personal tax return, the company must be a pass-through entity for income tax purposes. In early April, she files an S corporation election statement, giving the company pass-through status. She is further advised that since her investment was in a C corporation and she did not elect S corporation status until April, the stock qualifies for QSBS treatment. However, the S election is **retroactive** to the February 1st formation date for tax purposes and as a result the stock will not qualify for QSBS treatment.
- Taxpayer founded an S corporation and has operated it for two years. To facilitate the raising of capital, Taxpayer decides to convert the company to a C corporation. He is advised that this conversion will qualify the stock as QSBS. This advice may or may not be correct depending on the facts. If Taxpayer contributes the stock to a newly formed C corporation, the QSBS tests for the new company are determined on that date. However, if the simpler legal approach is taken and Taxpayer just revokes the S election, the original investment remains in the S corporation and the conversion cannot remove that taint for purposes of qualifying for QSBS treatment.

LLCs and Partnerships

Since the QSBS rules require a direct investment in a C corporation, LLCs and partnerships are potentially problematic as well. The following examples illustrate this potential trap:

- A group of founders fund the early R&D expenses of the business and for similar reasons to the S corporation election in the first example above, the company is formed as an LLC so these R&D losses pass through to the founders and can be claimed on the founders' personal tax returns. At a later date the company converts to a C corporation in order to raise outside financing. In this case, successful transformation to a C corporation that is eligible for QSBS treatment can be accomplished. The founders can form a new C corporation and contribute all of the equity of the existing LLC to the C corporation in exchange for C corporation stock. The founders will qualify for QSBS treatment because they received their stock directly from the C corporation.
- If the facts are the same as above but instead the preferred method to create the C corporation is a legal reorganization under state law (which may be necessary for non-tax reasons) rather than the formation of a new C corporation, advisors must be sure that such approach will be treated for tax purposes as a contribution of LLC **equity** by the LLC owners to the C corporation in exchange for C corporation stock. If instead, the tax treatment of the conversion is a contribution of the LLC **assets** to the new C corporation in exchange for C corporation stock and an immediate distribution of that stock to the original LLC owners, the stock will not meet the QSBS requirements. The LLC owners will not get QSBS treatment because they did not receive their stock directly from the C corporation.

Redemptions

For various reasons, companies are sometimes founded by individuals who do not stay with the company for very long. Depending on how these individuals leave, their exit can actually cause QSBS treatment to be disallowed for the other investors. The rules state that if a company redeems stock, that redemption could retroactively disqualify other individuals' investments within a window of two years before and two years after the redemption date. The following example illustrates this potential pitfall:

- Individuals A and B found Company. Within six months of founding, B decides to exit. During this time and over the next six months before B actually leaves, Company raises money from investors and some of the proceeds are used to completely redeem B. As a result of this redemption, neither A's founder shares nor the new investors' shares qualify for the QSBS exemption. Under this fact pattern, even stock grants to new employees can be disqualified. Given these harsh results, it is imperative that companies understand these rules when a founder exits.

Personal Trap: Giving QSBS Stock to Charity

While this particular issue does not directly impact QSBS treatment, it can lead to tax inefficiencies with respect to QSBS shareholders. Generally speaking, when taxpayers are well advised regarding charitable giving, they know that giving appreciated stock to charity is more tax efficient than giving cash. For example, assume a taxpayer has $100 of zero basis, publicly traded stock. If she sold it and gave away the cash, she would have $100 of gain and offsetting $100 of charitable deduction, which is a good answer but not optimal (and depending on state rules could create additional tax). Instead, if she simply gave the stock to charity, she would still recognize the $100 charitable deduction but not create additional income allowing that $100 charitable deduction to offset other income. The inefficiency here is giving away QSBS stock where your gain will be excluded. Instead, the taxpayer would be better off selling the QSBS and giving away other, highly appreciated long-term (held for over a year) capital gain stock.

Contributing QSBS to a Family Partnership

As entrepreneurs and their families become more successful, it has become common practice to form Family Investment Companies (FICs) to consolidate family investment activity and use these FICs as wealth transfer vehicles. While there are many tax and non-tax advantages to these entities, there is also a danger. While it is perfectly permissible to gift QSBS during life or bequeath it at death (as authorized by the statute), a taxpayer may not contribute QSBS to a partnership without disqualifying the stock as QSBS. Under the rules, a taxpayer must make a direct investment in a qualified C corporation in exchange for that company's stock. As soon as the FIC receives that transfer, the owner (now the FIC) and the direct investor are no long the same taxpayer. As a result, the stock is no longer QSBS. Once an individual owns QSBS he should never contribute it to a partnership. If it is desirable for the FIC to own QSBS, the entity must make the company investment directly. If structured correctly, the FIC can then sell the stock with no gain being allocated to the FIC owners. Alternatively, the FIC can distribute the QSBS to the owners and it will generally retain its characteristics as QSBS stock in their hands.

The QSBS exemption can be a very powerful tool for a small business and its owners. However, careful consideration must be given to the QSBS rules or taxpayers and their advisors may find they have derailed what can be enormous tax benefits.

Andersen Tax LLC. | 100 First Street, Suite 1600, San Francisco, CA 94105

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

Tax Law Changes Create New Opportunities to Obtain a Tax Basis Step-up in the Assets of an Acquired Corporation

Growth through acquisitions is a key component of many organizations' business strategy.

The ability for a buyer to obtain a tax basis equal to the fair market value of the target business's underlying assets, and therefore, the ability to enjoy future depreciation and amortization tax deductions for the value paid for the assets can have a meaningful impact on the economics of a transaction to the buyer and the purchase price that a buyer is willing to pay. As a result, buyers generally prefer to purchase the assets of a business, which allows them to depreciate or amortize the acquired assets at the fair market value purchase price, rather than purchase the stock of a C corporation where the historical tax basis of the target's assets carry over and continue to be depreciated or amortized at historical values.

However, if a buyer purchases the assets of a C corporation, and the corporation then distributes the proceeds from the sale to its shareholders in a liquidating distribution, the transaction is subject to two levels of tax. First, the corporation is taxed on any gain from the sale of the corporation's assets. Second, the shareholders are taxed on the subsequent liquidation of the corporation as if they sold their stock for the liquidation proceeds. These mechanics result in the double taxation of the asset sale proceeds and therefore, historically these asset purchases were rare due to the prohibitive tax cost to the corporation and its shareholders.

Besides these tax consequences there are sometimes business reasons for doing a stock purchase rather than an asset purchase (e.g., difficulty assigning key contracts, licenses or permits). The question then becomes, how can a corporate buyer obtain a fair market value (or stepped-up) tax basis in the target's assets when the target is a corporation and the transaction is for the acquisition of all of the corporation's stock?

Sec. 338 Election

The Internal Revenue Code provides for a special election to treat, solely for tax purposes, the purchase by a corporation of all the corporate stock as if the target corporation sold all of its assets to a new corporation. This election is found under Sec. 338, and is commonly referred to as a Sec. 338 election.

Like many areas of the tax law, there are multiple facets to the Sec. 338 election. Historically, a Sec. 338 election was most often utilized in the form a Sec. 338(h)(10) election, which is only applicable to target corporations that are S corporations or C corporations that are subsidiaries in a consolidated group. The Sec. 338(h)(10) election is useful to obtain a tax basis step-up in the target's assets without subjecting the sale to a full second level of tax. This result is accomplished through an increase in S corporation stock basis for the corporate gain on the deemed sale of assets, or a deemed liquidation of a C corporation subsidiary into its parent corporation immediately following the sale of its assets which is generally a tax-free Sec. 332 transaction.

In a C corporation acquisition, however, many practitioners have all but forgotten the regular Sec. 338 election that is not Sec. 338(h)(10), often referred to as a Sec. 338(g) election. The Sec. 338(g) election differs from the Sec. 338(h)(10) in that it creates tax at both the corporate and shareholder level (i.e., double taxation), just as if the transaction were for the purchase of the corporation's assets, and not a purchase of stock. However, since the deemed asset sale occurs after the actual stock sale, only the purchaser pays the tax on the deemed sale and receives a basis step-up on those assets. While Sec. 338(g) elections are typically used in conjunction with foreign target corporations not subject to U.S. tax, the domestic Sec. 338(g) election is rarely used and limited to very unique fact patterns. One such situation is where the target has expiring net operating losses (not subject to Sec. 382 limitations) that could offset the entire corporate gain on the deemed asset sale, effectively eliminating the corporate-level income tax.

Impact of Tax Reform

The tax law changes passed in December 2017 could alter how acquirers consider domestic Sec. 338(g) elections. First, the lower corporate tax rate and elimination of the corporate alternative minimum tax immediately reduces or eliminates the potential cost of a domestic Sec. 338(g) election. Any time there is a tax cost to obtain a basis step-up in the corporation's assets, the benefit of the step-up is typically measured in terms of the present value of future tax savings from the additional depreciation and amortization of the stepped-up asset basis, less the tax cost of obtaining the step-up. Therefore, while the reduced corporate tax rate lowers the potential upfront cost of a domestic Sec. 338(g) election, the impact swings both ways because it also lowers the present value of future tax savings.

Next, the changes to the bonus depreciation rules that permit immediate expensing for used property could provide significant benefits for capital intensive businesses with qualified property. Previously, the definition of qualified property under Sec. 168(k)(2)(A) required that the original use of the property commence with the taxpayer placing it in service. Now, so long as the property was not used by the same taxpayer prior to acquisition, it can qualify for the immediate expensing (until 2022) of the full amount allocable to those assets, not just of the step-up. This ability to take bonus depreciation on used property is changing how buyers look at the value of asset acquisitions. In situations where the target corporation is capital intensive and possesses considerable fixed assets eligible for immediate expensing, the fact pattern required to make a Sec. 338(g) election beneficial could be much broader than the narrow set of circumstances in which it made sense in the past.

Finally, with the reduced corporate tax cost of a Sec. 338(g) election, it is possible that under some circumstances buyers could view Sec. 338(g) as more advantageous compared to a Sec. 338(h)(10) election. The Sec. 338(g) election is a unilateral election made by the buyer only, and does not require consent of the seller. A Sec. 338(h)(10) election requires both the buyer and seller to jointly make the election, because its impact reaches directly to the sellers. Often, when negotiating the purchase of stock with a Sec. 338(h)(10) election there is a purchase price component for tax equalization payments to the selling shareholder(s) for any increase in net tax cost as a result of the deemed asset sale compared to a sale of stock. It is possible that a Sec. 338(g) election may be more advantageous compared to a Sec. 338(h)(10) election, even when a Sec. 338(h)(10) election is available, when considering the impact of tax equalization payments. Of course, it is also necessary to consider the tax cost of making the Sec. 338(g) election itself.

With the reduction in corporate tax rates, along with other aspects of tax law changes benefitting corporations, it is possible that there will be an increase in closely held businesses organized and taxed as C corporations, compared to the previously common pass-through entity structure (e.g., S corporations or partnerships). If so, the Sec. 338(g) election could become a more common tool for corporate buyers to use to obtain a tax basis step-up in the target corporation's assets.

Andersen Tax LLC. | 100 First Street, Suite 1600, San Francisco, CA 94105

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

What is this Stuff? Tax Planning Considerations for Investors in Virtual Currency

Virtual currency (or cryptocurrency) trading has captured the attention of private investors and seems to be more than a passing fad.

Unfortunately, guidance from IRS pertaining to related income tax issues has not kept pace with the proliferation of virtual currency trading. This article highlights key income tax compliance issues for investors dealing or transacting in virtual currency.

Capital Gain Treatment and Holding Period

The classification of virtual currency for tax purposes remains unsettled. The only guidance provided by IRS with respect to virtual currency to date is Notice 2014-21 (the Notice), which defines convertible virtual currency such as Bitcoin or Ethereum as property rather than currency for income tax purposes. Thus, the general tax principles applicable to property transactions should apply to virtual currency transactions. Accordingly, it follows that the character of the gain or loss from the sale of a virtual currency depends on whether the virtual currency is a capital asset in the hands of a taxpayer. For most casual investors, virtual currency will be a capital asset. To determine the gain or loss on a sale, a taxpayer must compare the fair market value of the virtual currency in U.S. dollars on the date of the transaction to the fair market value in U.S. dollars on the date acquired (cost basis). If the fair market value on the date of the transaction is higher than the cost basis, the taxpayer has a capital gain (if the cost basis is higher there is a capital loss). The holding period starts on the date acquired and will determine whether the capital gain or loss is taxed as short-term or long-term. If the virtual currency is held by an investor as a capital asset for more than one year from the date acquired, the gain or loss from the sale will be taxed at preferential long-term capital gain rates.

Gain Deferral and Like-Kind Exchanges

Although the issue of whether virtual currency qualifies for like-kind exchanges has been rendered moot by the new tax law (beginning in 2018, only real property will qualify for like-kind exchange treatment), the analysis is nonetheless helpful in considering the broader tax issues around virtual currency and does remain relevant for prior tax years. As most of those trading in virtual currency know, Bitcoin is not the only game in town. In fact, most investors frequently trade between different currencies, for example, using Bitcoin to buy Ethereum. The question of whether exchanging one virtual currency for another is a sale or exchange that results in taxable income is unanswered.

An exchange of property occurs for tax purposes if there is a material difference between the two properties exchanged. A material difference exists between two properties so long as they embody legally distinct entitlements. Imagine a taxpayer exchanged Bitcoin for Ethereum, two types of virtual currencies. Do these two virtual currencies have different legal entitlements that would therefore constitute different properties? If the answer is yes, it would seem that the exchange of Bitcoin for Ethereum would constitute a realization event.

Assuming the exchange of two different virtual currencies is a taxable exchange, could an investor reasonably argue it should be considered a like-kind exchange which can be deferred under Sec. 1031 of the Internal Revenue Code (the Code) for tax years prior to 2018? The like-kind exchange rules are used to defer gain when property held in a trade or business or for investment is exchanged for other property of like-kind (i.e., of the same nature or character). The like-kind exchange regulations exclude specific property like stocks, bonds, notes, or other indebtedness from qualifying, but do not specifically exclude virtual currency. Of course, these regulations were written long before virtual currency existed. The regulations do provide that intangible assets can be like-kind if they represent similar rights and the underlying assets are similar. To support a like-kind exchange position, a taxpayer would need to argue that two types of virtual currency (e.g., Bitcoin and Ethereum) confer the same rights, which may be difficult to do.

In addition to a like-kind exchange, the exchange of units of virtual currency could be considered similar to the exchange of two pieces of property, or barter. As a result, there may be reporting requirements. IRS has not expressly compared the exchange of virtual currency to a barter transaction, but taxpayers dealing in virtual currency should be aware that concepts underlying IRS' policy on barter (such as the constructive receipt doctrine) could be applied to virtual currency.

Charitable Contributions

Generally speaking, one way to manage the capital gains tax on appreciated property is through charitable giving. Virtual currency prices have surged to stratospheric levels over short periods of time, leaving investors with large unrealized gains. Recognizing this value, Donor Advised Funds (DAFs) and other qualifying charities have begun accepting Bitcoin and Ethereum donations and therefore charitable giving has become a viable way to manage the taxes on virtual currency gains. There are, however, a few potential traps for the unwary. First, in order to benefit from a deduction for the fair market value of donated property, a taxpayer must hold the asset for more than one year. Given the rapid increase in value of Bitcoin and other virtual currencies, most new investors will not meet the holding period requirements and will only receive a deduction for the cost basis of their virtual currency assets. Secondly, despite the availability of market prices on Coinbase and similar trading platforms, it is not clear that virtual currencies will be considered qualified appreciated property for which a quotation is available on an established securities market as is required by Sec. 170(e)(5)(B)(i) of the Code. Thus, it may be necessary to obtain a qualified appraisal of virtual currency assets donated to a charity. Finally, since the prices of virtual currencies can fluctuate so wildly (even within an hour), as a practical matter it may be difficult to pinpoint the value of the virtual currency donated. When donating marketable securities, the value of the donation is generally the average of the high and low stock price for the day of donation. Given this formula and the realities that Bitcoin prices for example can change 10% to 20% in a day, a donor may not get the anticipated deduction.

Tax Lot and Wash Sale Considerations

While IRS has not opined as to whether virtual currency should be treated as a security, the Securities and Exchange Commission (SEC) is treating virtual currency as such. The distinction is important for purposes of identifying the cost basis of virtual currency assets sold during the year. If a taxpayer were to treat virtual currency as a security, and IRS is treating virtual currency as property and not currency, it would follow that tax lot rules used for determining cost basis of securities sold should also apply. If an individual owns one lot of Bitcoin with a basis of $1,000 and another lot of Bitcoin with a basis of $9,000, it seems reasonable that he or she can choose which lot to use in a sale or exchange. However, because virtual currency exchange platforms usually do not keep track of basis like securities exchange platforms do, it is important for taxpayers to carefully keep track of their own basis. Without an established method to track basis and accurate record keeping, a taxpayer may be forced to use an arbitrary method for determining basis when selling or exchanging virtual currency. Given the volatility of various virtual currencies, determining which particular lot is sold can have an enormous impact on the tax paid.

In a related issue, taxpayers transacting with virtual currency must also consider IRS wash sale rules applicable to the sale of stocks and securities. Under the wash sale rules, the loss on the sale of a security is disallowed when a taxpayer sells or trades a security at a loss and purchases a substantially identical security within 30 days before or after the sale. Since IRS has not opined whether virtual currency is a security it is unclear whether the wash sale rules should apply.

Bitcoin Cash – Is it Taxable?

It is not uncommon for owners of a specific virtual currency to change the code underlying the blockchain (i.e., a continuously growing list of records linked and secured using cryptography). For example, they may do this to improve security features of the blockchain. As a result, existing virtual currency owners receive rights to a new virtual currency without giving back any of the old currency, an event known as a fork. The most notable fork occurred in 2017 when Bitcoin holders received a new currency called Bitcoin Cash (BCash). A fork seems to be an entirely new type of event and analysis of the income tax implications falls into uncharted waters. Unfortunately, IRS has not issued any guidance regarding how they will view a fork so taxpayers need to consider different tax treatments.

- **Should a fork be treated like a dividend?** Since virtual currency is not considered a corporate security, it seems unlikely that the dividend rules would apply since they are for distributions of cash or property out of the earnings of a corporation.
- **Should a fork be treated like a property division that may be tax-free under the same rules that govern a stock split or spinoff?** A division of corporate stock will create taxable income for the shareholder unless it is structured properly to fit under certain exceptions that are specifically written into the Code. Those exceptions fall under corporate tax law that applies to stocks and securities. Since virtual currency is not classified as a stock or security for tax purposes, it is hard to conclude that a fork falls under those exceptions. An analogy could be made to a tax-free property division such as dividing one parcel of real estate into two or more. However, in such a case no new property is created, so the analogy to a fork, where a second virtual currency distinct from the first is created and there is no diminution of the first, may not fit.
- **Should a fork be treated as ordinary income?** Based on the above, it would seem that the most realistic position is that the value of the new currency received in a fork should be ordinary income, but such position is conjecture. It is unlikely to be considered capital gain as there was no sale or exchange of a capital asset. Likewise, since IRS has indicated virtual currency is not actually currency, a fork would not be considered a currency exchange.

Information Reporting

Along with numerous uncertainties in the taxation of virtual currencies, taxpayers also face information reporting issues due to the lack of records and regulations. Of course, these issues do not exempt taxpayers and vendors from information reporting requirements. If a taxpayer receives wages in the form of virtual currency, the fair market value of the virtual currency paid as compensation should be reported on Form W-2, and those wages are still subject to federal income tax withholding. Likewise, if paid as other income for the performance of services, the information reporting requirements for Form 1099 apply as well. In addition, as indicated above taxpayers are also responsible for keeping track of their cost basis and reporting gains and losses, even if the exchange platform they use does not. These inherent complications promise to create reporting questions for both taxpayers and their advisors.

The Takeaway

Determining the tax implications of virtual currency transactions for investors is complicated and, unfortunately, IRS has thus far provided little guidance to help along the way. Limited legislation has been proposed but to date has not gathered widespread support in Congress. In the absence of clear guidance, each virtual currency transaction should be analyzed based on its specific facts and circumstances. Due to the uncertainty regarding the proper tax treatment and reporting of virtual currency transactions, it is important to consult with a tax specialist who is familiar with these issues.