Tax Impact

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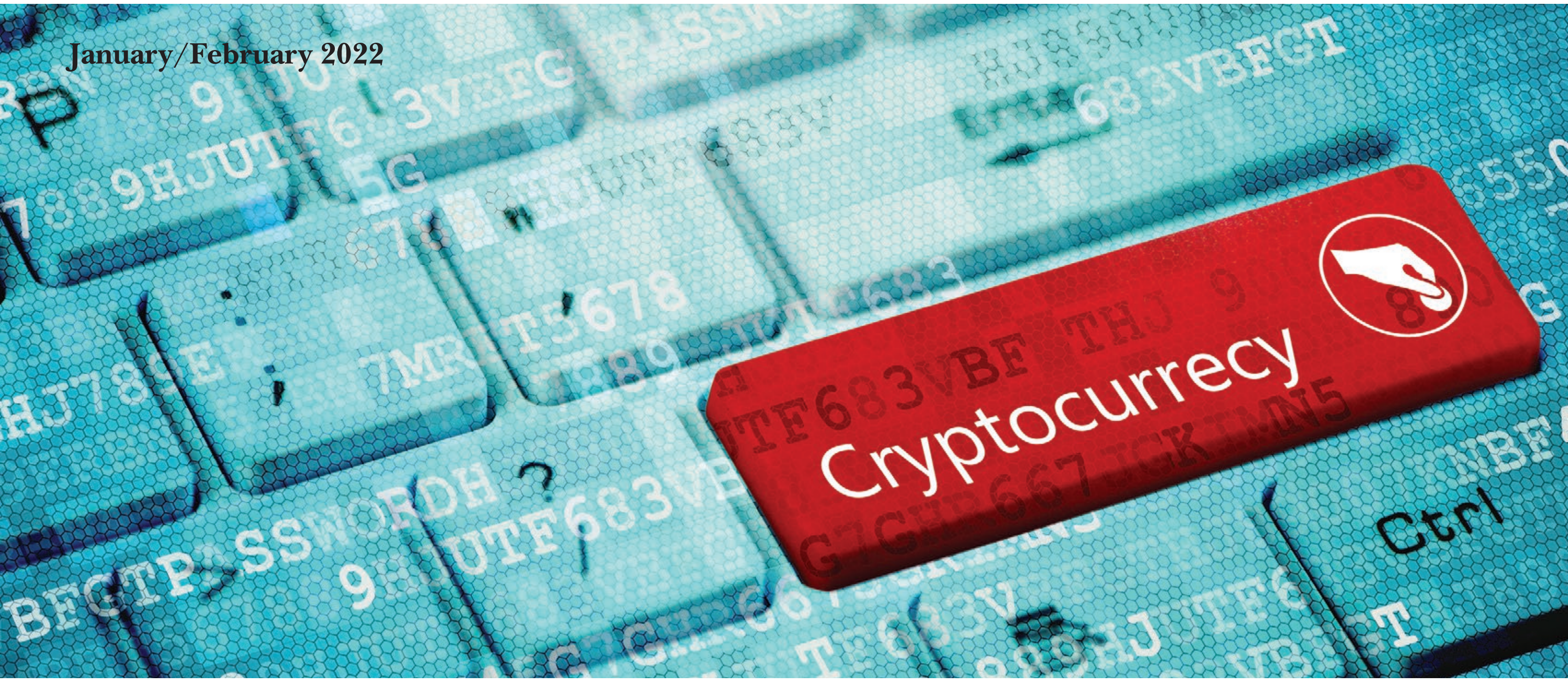

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Got crypto?

Beware of tax surprises when dealing with cryptocurrencies

In recent years, interest in cryptocurrencies — such as Bitcoin and Ethereum — has exploded. Once viewed as a novelty, these currencies are increasingly entering the mainstream as an investment or an alternative currency. If you've jumped on the cryptocurrency bandwagon, it's important to understand the tax implications.

Owners are often surprised to discover that when they use cryptocurrency to purchase goods or services, they may trigger capital gains or losses they must report on their tax returns. Even investors who buy and hold cryptocurrencies may have to report taxable income when certain events take place on the blockchain or other digital ledger system on which cryptocurrency transactions are recorded.

Currency vs. property

The IRS treats cryptocurrency (also called virtual currency) as property. That means when you sell cryptocurrency in exchange for traditional currency, you must recognize a capital gain or loss. The amount of that gain or loss, as with other types of property, is the difference between the sale price and your adjusted basis in the cryptocurrency. Generally, your basis is the amount you spent (in U.S. dollars) to acquire the virtual currency, including fees, commissions and other acquisition costs.

Your gain or loss may be short-term or long-term, depending on whether you've held the cryptocurrency for more than one year. Keep in mind that if you sell cryptocurrency at a loss, you're subject to the same deduction limits as other capital losses.

Purchases of goods or services

Perhaps the biggest tax surprise involving cryptocurrency is that using it to purchase goods or services can trigger a capital gain or loss. That's because, unlike a purchase using traditional

currency, a cryptocurrency transaction is treated as an exchange of one property for another. Your gain or loss is the difference between the fair market value (FMV) of the goods or services you acquire and your adjusted basis in the cryptocurrency you use to make the purchase.

Suppose, for example, that you own 10 Bitcoin that you purchased in 2018 for $5,000 each, for a total of $50,000. In 2021, on a date when the FMV of one Bitcoin had skyrocketed to $50,000, you used four Bitcoin to buy a Tesla Roadster with an FMV of $200,000. Assuming your adjusted basis in the Bitcoin is $5,000 each, your purchase generates $180,000 in long-term capital gain ($200,000 – $20,000).

From the perspective of the seller or service provider, payments made in cryptocurrency must be reported as income, based on the FMV of the cryptocurrency when the payments are received.

Payments to employees or contractors

Just like traditional currency, cryptocurrency may be used to pay employees' wages or to pay independent contractors for their services. The company must track the cryptocurrency's FMV as it's paid and then report the cumulative FMV for the tax year on Forms W-2 or 1099.

Reporting cryptocurrency on your tax return

If you've bought, sold or used cryptocurrency, it's important to understand your reporting obligations for federal tax purposes. Beginning with the 2020 tax year, Form 1040 includes the following question, directly below the taxpayer's general information section: At any time during 2020, did you receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?

According to IRS guidance, if you purchased cryptocurrency with "real" currency in 2020, and had no other cryptocurrency transactions during the year, you may answer "no." However, if you sold cryptocurrency or used it to purchase goods or services during the year, you must answer "yes" and report these transactions on Schedule D, *Capital Gains and Losses*. And, of course, you must report any W-2 wages or 1099 income received in cryptocurrency.

Likewise, the recipient must report the cryptocurrency payment as income, based on its FMV when it's paid. The usual rules apply regarding income tax withholding, payroll taxes and self-employment taxes.

A company also may have a taxable gain or loss due to appreciation or decline in the FMV of the cryptocurrency during the time it was held before it was paid to the employee or independent contractor. Assuming the company isn't in the trade or business of buying and selling virtual currencies, the gain and loss will be a capital gain or capital loss (short-term or long-term depending on how long it was held).

Digital ledger events

Even if you don't conduct any transactions using cryptocurrency, certain events on the blockchain or other digital ledger may generate taxable gain. IRS guidance describes two such events:

1. A "hard fork," which essentially means that a single cryptocurrency is split into two, and

2. An "airdrop," which may or may not follow a hard fork, is "a distribution of cryptocurrency to multiple taxpayers' distributed ledger addresses" — in other words, the developer of the new cryptocurrency drops "free coins" into owners' digital wallets.

According to IRS guidance, a hard fork by itself doesn't trigger taxable income. But if the new cryptocurrency is airdropped or otherwise transferred to owners' accounts, and owners have the ability to immediately dispose of the new cryptocurrency, then they must recognize it as ordinary income.

Documentation is critical

Because the value of cryptocurrency fluctuates widely and frequently, it's critical to maintain records that show the dates and prices of all your cryptocurrency purchases and sales. You should also keep thorough records of any transactions involving cryptocurrency, such as purchases or sales of goods or services, including the cryptocurrency's FMV on the dates that payments are received.

If you purchase cryptocurrency on different dates for different prices, it may be possible to specifically identify the units you're selling or otherwise disposing of. This provides an opportunity to minimize capital gains by selecting the units with the highest adjusted basis. If you don't (or can't) specifically identify the units, then you must use the first-in, first-out method — in other words, you're presumed to dispose of the oldest units, which may increase your tax liability. ■

Wealth protection

How to shield assets from creditors' claims

Generally, most people concentrate their asset-protection efforts on insulating their personal wealth from frivolous lawsuits or other claims. But if a significant portion of your wealth is invested in a business, it's equally important to protect its assets from unreasonable or excessive creditor claims. Let's take a look at several asset-protection strategies available for a wide range of assets.

Personal assets

The way you handle the personal assets comprising your estate can make a big difference. For instance, you and your spouse may own your home or other real estate as joint tenants with rights of survivorship (JTWROS), for convenience's sake. But this exposes the property to the reach of creditors.

Alternatively, a couple might arrange to own the property as a tenancy by entirety, when permissible under state law. As with JTWROS, the property automatically passes to the surviving spouse on the death of the other. However, in this case, the property can't be used to satisfy a judgment against the other spouse.

Also, note that you can use the annual gift tax exclusion to reduce the size of your taxable estate without tapping your gift and estate tax exemption. For 2022, the gift tax exclusion is $16,000 per recipient ($32,000 for joint gifts by a married couple).

Insurance policies

One way to protect your assets from creditors is to secure adequate insurance coverage. This includes several types of insurance policies.

Start off with liability insurance for your business. This is especially important for physicians, attorneys and other professionals who are frequent lawsuit targets and must rely on malpractice insurance.

Similarly, by acquiring adequate automobile and homeowner's insurance, you can guard against a financial catastrophe. Make sure you understand the key elements, including what's covered, the policy limits and which exclusions apply.

You can buy life insurance naming your spouse and children as beneficiaries. If certain requirements are met, the proceeds won't be included in your taxable estate. This is often accomplished through an irrevocable life insurance trust (ILIT).

Business ownership

If you have business interests or real estate holdings at risk, the form of business ownership is critical. Essentially, an entity may be used to distinguish business assets from personal ones and thereby limit a creditor's ability to seek recovery.

For example, if you're a sole proprietor or a partner in a partnership, you usually face unlimited personal liability for business debt. One protection method is to form a corporation or a limited liability company (LLC) for the business. Generally, this reduces your exposure. However, make sure you understand all the tax and legal implications.

One way to protect your assets from creditors is to secure adequate insurance coverage.

Trusts

Entire books have been written about the use of trusts to protect personal assets. While trusts have many variations and uses, one of their main attractions is their general ability to shelter assets from creditors.

Notably, to protect your assets from judgments, the trust must be irrevocable. This means you can't revoke it or maintain control over the assets.

For example, when permitted under state law, you might establish a "spendthrift trust" designed to protect funds accessible to beneficiaries like young children or grandchildren. The designated trustee controls the disposition of assets until the beneficiaries reach a specified age.

As mentioned above, an ILIT may be used to provide life insurance proceeds without including them in your taxable estate. A trust may also incorporate charitable giving through a charitable remainder trust or charitable lead trust.

Don't risk your wealth

No matter how successful you are at building wealth, if you don't protect your assets from a lawsuit or an unreasonable creditor's claim you risk the chance that you'll have nothing left to pass to your heirs. Your estate planning advisor can help you implement specific asset-protection strategies that are right for your situation. ■

Employer-provided child care credit helps businesses help their workers

The COVID-19 pandemic has led to a significant increase in the number of employees working from home. Given the convenience of remote work, especially for parents of young children, employers of in-person workers are under increasing pressure to provide child care.

Fortunately, the tax code provides an incentive, in the form of the Section 45F employer-provided child care credit. Here's how it works.

The basics

The Sec. 45F credit is part of the general business credit, which is composed of more than 30 separate tax credits that are subject to combined limits based on your tax liability. To calculate and claim the credit, a business files Form 8882, *Credit for Employer-Provided Child Care Facilities and Services.*

The credit is equal to 25% of an employer's qualified child care facility expenditures plus 10% of its qualified child care resource and referral expenditures paid or incurred during the tax year. It's limited to a total of $150,000 per tax year.

Facility expenditures

Qualified child care facility expenditures are amounts paid:

- To acquire, construct, rehabilitate or expand property that's 1) to be used as part of a qualified child care facility of the taxpayer, 2) depreciable or amortizable, and 3) not part of the principal residence of the taxpayer or one of the taxpayer's employees;
- To operate a qualified child care facility of the taxpayer, including expenses for training, scholarship programs and increased compensation for employees with child care training; or
- Under a contract with a qualified child care facility to provide child care services to taxpayer's employees.

To qualify, expenses must not exceed the fair market value of the child care provided. A qualified child care facility is one that meets all state and local regulatory requirements *and*:

- Is used principally to provide child care (unless it's also the personal residence of the person who operates it),
- Is open to all of the taxpayer's employees during the tax year, and
- Doesn't discriminate in favor of highly compensated employees.

In addition, if the facility is the taxpayer's principal trade or business, at least 30% of enrollees must be dependents of the taxpayer's employees.

Special rules and restrictions

Qualified expenditures are amounts paid under a contract to provide resource and referral services to help a taxpayer's employees find child care. To avoid double benefits from the same expenditures, the taxpayer must reduce its basis in any qualified child care facility by the amount of the credit attributable to facility-related expenditures. The taxpayer must also reduce other deductions or credits that are based on the same expenses.

The Sec. 45F credit is part of the general business credit, which is composed of more than 30 separate tax credits.

Taxpayers may have to recapture (pay back) some or all of the credit if a qualified child care facility ceases to operate as such, or undergoes a change in ownership, before the tenth tax year after the tax year in which it's placed in service. The percentage of the credit that must be recaptured decreases gradually over the 10-year period.

Valuable recruiting tool

As employers compete for a shrinking labor pool and remote work becomes more common, employer-provided child care can be an attractive perk for current and prospective employees. The Sec. 45F tax credit can help reduce the cost of these benefits. ■

Tax Tips

Watch out for tax scams

As tax season ramps up, taxpayers should be on the lookout for common scams that tend to peak this time of year. The IRS annually publishes its Dirty Dozen list of the worst tax-related scams. Two examples from the 2021 list include:

- Unemployment fraud, in which scammers file fraudulent claims for unemployment compensation using stolen personal information. Watch out for a Form 1099-G reporting unemployment compensation you didn't receive.

- Phishing, in which scammers use fake emails, text messages, websites or social media platforms to steal your personal information. These communications are cleverly disguised to look like they're from the IRS or other legitimate sources, but the IRS never initiates contact with taxpayers in this way. Beware of communications making threats and those promising a big refund or a missing stimulus payment.

There are many other tax scams to look out for. If you're uncertain whether a tax-related communication is legitimate, consult your tax advisor. ■

ABLE accounts can help disabled family members

If you want to provide financial assistance to a disabled family member, consider an Achieving a Better Life Experience (ABLE) account. These tax-advantaged savings accounts are designed for people who became blind or disabled before age 26 and are eligible for Supplemental Security Income (SSI) or Social Security Disability Insurance (SSDI).

Contributions, up to the annual gift tax exclusion of $16,000 per year, aren't tax deductible. However, the funds grow tax-free and earnings may be withdrawn free of federal income tax if used to pay qualified expenses, including health care, education, housing, transportation, employment training and assistive technology expenses. Note also that in certain circumstances the beneficiary will be permitted to make contributions beyond the amount of any gift made to the account.

An ABLE account doesn't affect the beneficiary's Medicaid eligibility. But account balances over $100,000 count toward the $2,000 SSI individual resource limit. ■

MTC updates guidance on internet activities

If your business has an internet presence, be sure to review the Multistate Tax Commission's updated guidance on the Interstate Income Act. It generally prohibits states from imposing tax on income derived from interstate commerce if business activities in the state are limited to solicitation of orders sent outside the state for approval and filled from a point outside the state.

The new guidance, among other things, lists several internet activities that aren't protected by the act (and therefore may trigger income tax liability). Examples include regularly providing post-sales assistance via electronic chat or email, soliciting and receiving online credit card applications, and inviting website visitors to apply for non-sales positions via a web-based platform. ■