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Tax & Business Alert

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CURTAILING TAX SURPRISES WITH CRYPTOCURRENCY

As investing in Bitcoin, Dogecoin and other cryptocurrencies becomes increasingly popular, investors need to understand the potential tax ramifications. Unlike traditional currency, the IRS views cryptocurrency as *property* for federal income tax purposes and even asks about it on IRS Form 1040.

Many transactions involving cryptocurrency — such as purchases of goods or services — become taxable events where the purchase is also considered a sale. In addition, certain changes to the blockchain (the distributed digital "ledger" on which cryptocurrency transactions are typically recorded) can trigger taxable income.

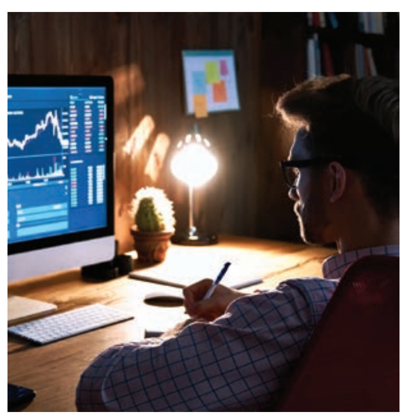
GAINS AND LOSSES

Because cryptocurrency is property, investors recognize a capital gain or loss when they sell it in exchange for traditional currency. As with other capital assets, the amount of gain or loss is the difference between the adjusted basis in the cryptocurrency (usually, the amount paid to acquire it) and the amount for which it's sold. And, as with other capital assets, gain or loss may be short term or long term, depending on whether an investor held the cryptocurrency for more than one year. If cryptocurrency is sold at a loss, there may be limitations on the deductibility of the capital losses.

Cryptocurrency owners often are surprised to discover that using cryptocurrency to pay for goods or services can also trigger a capital gain or loss. Let's say you purchased 10 units of cryptocurrency 10 years ago for $1,000 each, or a total of $10,000. This year, when the cryptocurrency's price has climbed to $5,000 per unit, you use it to purchase a $50,000 car. Assuming your adjusted basis in the cryptocurrency is $10,000, you'll recognize a $40,000 long-term capital gain. Generally, your gain or loss is the difference between your adjusted basis in the cryptocurrency and the fair market value of the goods or services you receive in exchange for it.

FORKS AND DROPS

In some cases, a cryptocurrency owner may recognize taxable income because of certain blockchain events. Taxable income may be triggered even if you don't conduct transactions or take any other actions with the cryptocurrency.



IRS guidance in 2019 addressed the tax implications of two types of blockchain events: "hard forks" and "airdrops." A hard fork occurs "when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger." Put much more simply, it's when a single cryptocurrency is split in two.

A hard fork may or may not be followed by an airdrop, which the IRS describes as "a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers." According to the guidance, when an airdrop follows a hard fork, it "results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency." In simpler terms, it's when "free coins" representing the new cryptocurrency are dropped into the existing cryptocurrency wallets of the owners of the legacy cryptocurrency.

If the new cryptocurrency isn't airdropped or otherwise transferred to an account of the legacy cryptocurrency's owner, a hard fork doesn't trigger taxable income. On the other hand, if a hard fork is followed by an airdrop (which enables owners to immediately dispose of the new cryptocurrency), the owner recognizes ordinary income in the year the new cryptocurrency is received.

STAY CURRENT

Buying and selling cryptocurrency involves significant risk, including the possibility you could lose part or all of the money you've invested. Tax treatment of cryptocurrency is also subject to change. The IRS will likely continue to provide guidance on the distinctive tax issues presented by cryptocurrency. We can help you stay current on these developments and work with you to avoid unpleasant tax surprises. ■

FAMILY BUSINESSES MUST BEWARE OF FRAUD

Family businesses make up a huge percentage of companies in the United States and produce much of the country's gross domestic product. Generally defined as companies that are majority owned by a single family with two or more members involved in their management, family businesses can be a significant source of wealth.

However, for various reasons, they may also potentially face higher fraud risk. Here's why, and how you can reduce that risk.

MAJOR OBSTACLES INVOLVED

Why might family businesses be more vulnerable to fraud than other companies? For one thing, prevention efforts can be hampered by loyalty and affection. One of the biggest obstacles to fraud prevention is simply acknowledging that someone in the family could be capable of initiating or overlooking unethical or illegal activities.

But like any other business, family enterprises must include a system of internal controls that make fraud difficult to perpetrate. It may be awkward to exercise authority over members of one's own family, but someone needs to take charge if or when issues arise. Sometimes family businesses need to hit the reset button and reestablish a hierarchy and process of authority while moving forward with the enterprise.

ADVANTAGE OF INDEPENDENT ADVICE

Of course, the person in charge potentially could be the one defrauding the company. That's why independent auditors and legal advisors are critical.

Your family business should look outside its immediate circles of relatives and friends to retain professional advisors who can be objective when assessing the company. Audited financial statements from independent accountants protect the business and its stakeholders.

If your company is large enough to have a board of directors, it should include at least one outsider who's strong enough to tell you things you may not want to hear. In some extreme cases, members of all-family boards have been known to work together to bilk their companies. This becomes much more difficult to do when collusion requires the assistance of an outsider.

PUNISHING THE PERPETRATOR

Another factor that makes preventing fraud in family businesses hard is how they tend to handle fraud incidents. Even when legal action is an option, families rarely can bring themselves to pursue action against one of their own. Sometimes families choose to save the fraudster from public scandal or punishment rather than maintain ethical professional standards. Most fraud perpetrators know that.

If you discover a family member is committing fraud, ask a trusted attorney or accountant to explain to the perpetrator the illegality and possible consequences of the fraudulent actions. If such interventions don't work, however, you and other family members may have no choice but to seek prosecution.

AVOID BLIND TRUST

There are plenty of advantages to working with family members, but you also need to watch for pitfalls. To maintain high ethical standards and prevent fraud, rely on professional advisors and nonfamily officers to provide perspective and objective advice. Contact us for help with internal controls. ■

ARE SCHOLARSHIPS TAXABLE?

Many young adults are heading off or back to college in the fall. It's particularly exciting this year because of high hopes that, thanks to mass vaccinations, students will be able to have something approaching a traditional college experience.

If your child has been awarded a scholarship, that's cause for celebration, too! But be aware that there may be tax implications.

GENERALLY, BUT NOT ALWAYS

Scholarships (and fellowships) are generally tax-free for students at elementary, middle and high schools, as well as those attending college, graduate school or accredited vocational schools. It doesn't matter if the scholarship makes a direct payment to the individual or reduces tuition.

Subject to limited exceptions, however, a scholarship *isn't* tax-free if the payments are linked to services that your child performs as a condition for receiving the award — even if the services are required of all degree candidates. Therefore, a stipend your child receives for required teaching, research or other services is taxable, even if the child uses the money for tuition or related expenses.

What if you, or a family member, is an employee of an education institution that provides reduced or free tuition? A reduction in tuition provided to you, your spouse or your dependents by the school at which you work isn't included in your income or subject to tax.

RETURNS AND RECORDKEEPING

If a scholarship is tax-free and your child has no other income, the award doesn't have to be reported on a tax return. However, any portion of an award that's taxable as payment for services is treated as wages. Estimated tax payments may have to be made if the payor doesn't withhold enough tax.

Your child should receive a Form W-2, "Wage and Tax Statement," showing the amount of these "wages" and the amount of tax withheld. Any portion of the award that's taxable must be reported, even if no Form W-2 is received.

BASIC RULES

These are just a few of the basic rules. Other rules and limitations may apply. For example, if your child's scholarship is taxable, it may limit other higher education tax benefits to which you or your child are entitled. As we approach the new school year, best wishes for your child's success. Please contact us if you wish to discuss this or any other tax matter. ■

TAX CALENDAR

July 15

If the monthly deposit rule applies, employers must deposit the tax for payments in June for Social Security, Medicare, withheld income tax and nonpayroll withholding.

August 2

The second quarter Form 941 ("Employer's Quarterly Federal Tax Return") is due today. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

August 16

If the monthly deposit rule applies, employers must deposit the tax for payments in July for Social Security, Medicare, withheld income tax and nonpayroll withholding.

September 15

Third quarter estimated tax payments are due for individuals, trusts, and calendar-year corporations and estates.

- If an extension was obtained, partnerships should file their 2020 Form 1065 by this date.
- If an extension was obtained, calendar-year S corporations should file their 2020 Form 1120S by this date.
- If the monthly deposit rule applies, employers must deposit the tax for payments in August for Social Security, Medicare, withheld income tax and nonpayroll withholding.

September 30

Calendar-year trusts and estates on extension must file their 2020 Form 1041.

A TAX QUIRK OF BEING A BUSINESS PARTNER

If you're a partner in a business, you may have encountered a situation that gave you pause. In any given year, you may have been taxed on more partnership income than was distributed to you. The cause of this quirk of taxation lies in the way partnerships and partners are taxed.

Unlike regular corporations, partnerships aren't subject to income tax. Instead, each partner is taxed on the partnership's earnings — whether or not they're distributed. Similarly, if a partnership has a loss, the loss is passed through to the partners. (However, various rules may prevent partners from currently using their share of a partnership's loss to offset other income.)

While a partnership isn't subject to income tax, it's treated as a separate entity for purposes of determining its income, gains, losses, deductions and credits. This makes it possible to pass through to partners their share of these items.

A partnership must file an information return, which is IRS Form 1065, "U.S. Return of Partnership Income." On this form, the partnership separately identifies income, deductions, credits and other items. This is so partners can properly treat items that are subject to limits or other rules that could affect their treatment at the partner level. Examples of such items include capital gains and losses, interest expense on investment debts, and charitable contributions. Each partner gets a Schedule K-1 showing his or her share of partnership items.

Basis and distribution rules ensure that partners aren't taxed twice. A partner's initial basis in his or her partnership interest (which varies depending on how the interest was acquired) is increased by his or her share of partnership taxable income. When that income is paid out to partners in cash, they aren't taxed on the cash if they have sufficient basis. Instead, partners reduce their basis by the distribution amount. If a cash distribution exceeds a partner's basis, then the excess is taxed to the partner as a gain (often, capital gain). Contact us to discuss further. ■