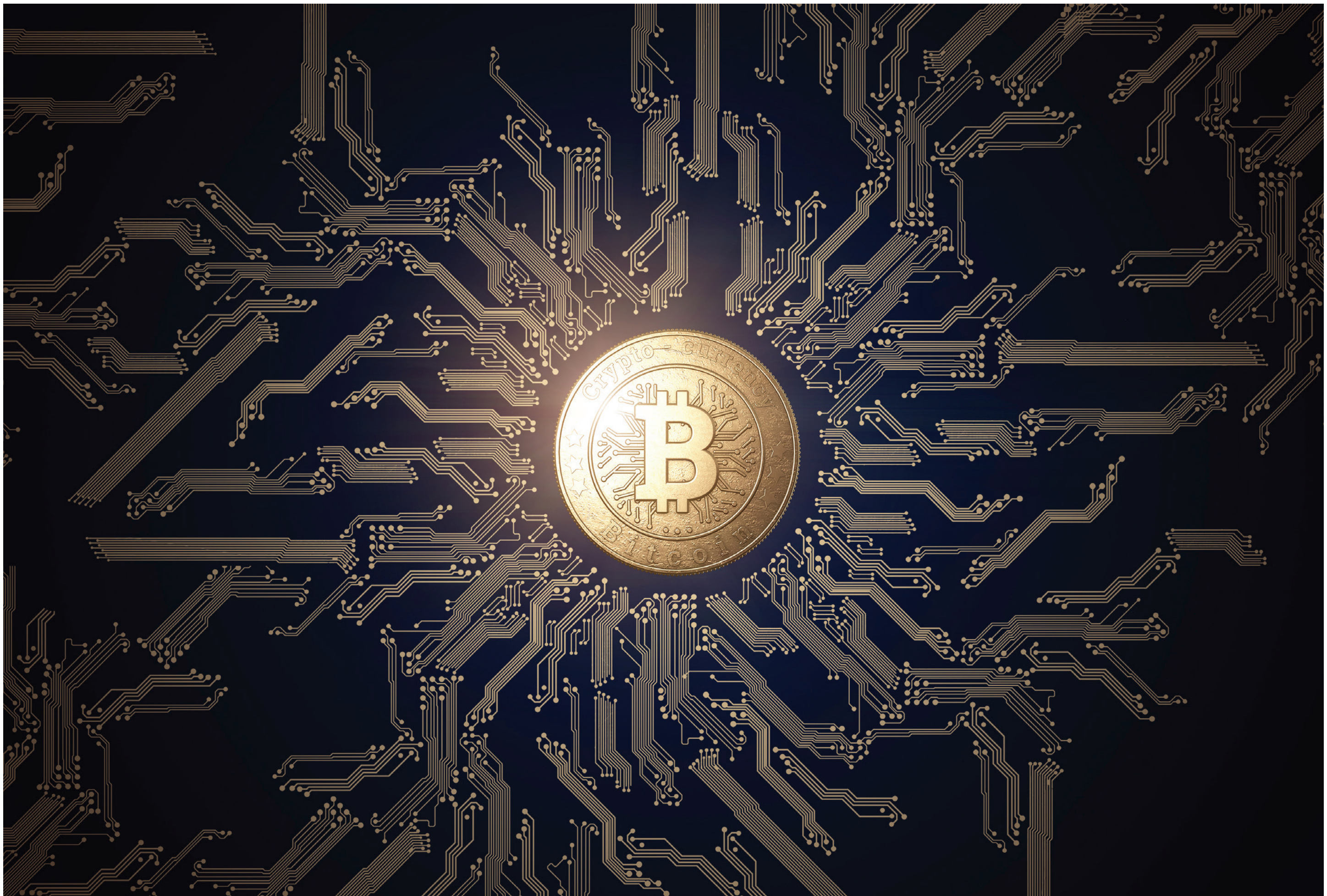

Accounting for cryptocurrency:
A challenge and opportunity for CPA firms and professionals

The growing popularity of virtual currencies presents a chance for firms to grow their business by offering cryptocurrency advisory, compliance, and auditing services.

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Introduction

Since its introduction in 2008, cryptocurrency has increased acceptance and use. This trend will continue as more people seek decentralized, private, and portable currency in a global economy.

This is good news for CPA professionals. The sheer number of cryptocurrency options is overwhelming, and there are aspects of fraud to consider, so people are likely to need advice from tax and accounting professionals.

CPAs who become cryptocurrency experts can take advantage of this opportunity. By offering cryptocurrency advice and auditing services, firms can realize a new revenue source to offset the loss of income from traditional services.

In this white paper, we examine the three different paths CPA firms can take to help cryptocurrency clients and the importance of continuing education for tax and accounting professionals to take advantage of these new opportunities.

How people use cryptocurrency

As cryptocurrency becomes mainstream, tax and accounting clients will likely be looking at cryptocurrency in three ways:

- **As an investment vehicle.** Cryptocurrency has created an alternative investment market for people looking to grow their money. But a lightly regulated market means the protections typically available for traditional investments may not apply to cryptocurrency.
- **To transact business as either a payor or payee.** While it's difficult to make straight-to-vendor crypto transactions, a growing number of platforms are enabling businesses to take .cryptocurrency.
- **To raise capital, although this is less frequently the case.** The ability to raise money via an initial coin offering (ICO) is attractive to businesses looking to generate capital for a product or service. The newness of the vehicle and the complexity of the process have constrained adoption so far.

Power definitions

- **Blockchain:**[1] A digital, public ledger that records online transactions. Blockchain is the core technology for cryptocurrencies.
- **Cryptocurrencies:**[2] Decentralized digital assets that use computer-generated cryptography as an encryption mechanism for security. Cryptocurrencies are autogenerated, which means they're created by computing processes inside a blockchain.
- **Cryptography:**[3] The mathematical and computational practice of encoding and decoding data.
- **Initial coin offering:**[4] The cryptocurrency industry's equivalent to an initial public offering. A company looking to raise money to create a new coin, app, or service launches an ICO to raise funds. Interested investors can buy into the offering and receive a new cryptocurrency token issued by the company.

How CPAs can help: Compliance

Compliance is the most immediate, accessible line of cryptocurrency business for firms.

To help clients file properly, firms must get educated on IRS rulings about cryptocurrency. The IRS first weighed in on cryptocurrency in 2014 with Notice 2014-21. In this, the IRS applied general tax law principles to determine that virtual currency is property for federal tax purposes.

In 2019, the IRS issued Revenue Ruling 2019-24, which covers "autogenerated" cryptocurrency. While the guidance is straightforward for firms, clients may find it complex. Because cryptocurrency can present events where income is generated in ways that don't have traditional currency parallels.

Tax and accounting professionals must understand these two pieces of guidance. Since IRS guidance is constantly evolving, firms should watch for changes, for what happens next, and for where the guidance goes.

Below are some common compliance questions and answers to help firms better serve clients:

- **How is cryptocurrency taxed?**
  - Virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency. Any taxpayer who mines cryptocurrency, sells or exchanges cryptocurrency holdings, and/or receives cryptocurrency as payments for goods or services must pay taxes on it.
- **How is cryptocurrency fair market value (FMV) determined?**
  - FMV is determined by converting the cryptocurrency into U.S. dollars based on the valuation established by whatever exchange lists it. If an exchange is not used, FMV is determined by a cryptocurrency or blockchain explorer.
- **Are clients responsible for gains and losses?**
  - Yes. If the FMV of property received in exchange for virtual currency exceeds the cryptocurrency's adjusted basis, that is a taxable gain. If the FMV of the property received is less than the adjusted basis of the virtual currency, that constitutes a loss.
- **What kind of gain or loss is realized?**
  - In most situations, gain or loss will be capital in nature because clients typically hold cryptocurrency for investment purposes. A client will generally realize ordinary gain or loss on the sale or exchange of cryptocurrency that is not held as a capital asset.
- **What about cryptocurrency received by clients working as independent contractors?**
  - This would be included in gross taxable income and subject to self-employment tax. Also, a person who, during a trade or business, makes a payment using virtual currency with an FMV of $600 or more must report the payment to the IRS and the independent contractor.
- **What about cryptocurrency received by a client working as an employee for a business?**
  - this income is taxable alongside all other currencies.
- **Are payments made via cryptocurrency subject to backup withholding?**
  - Yes, just like other payments made on property.
- **Does a taxpayer realize gross income as a result of a cryptocurrency hard fork if the taxpayer does not receive units of a new cryptocurrency? A hard fork happens when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the old or existing distributed ledger. A hard fork may also result in the creation of a new cryptocurrency on a new distributed ledger.**
  - Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger; transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger.
  - Revenue Ruling 2019-24 concludes that a taxpayer does not have gross income under section 61 as a result of a hard fork if the taxpayer does not receive units of the new cryptocurrency.

- **Does a taxpayer realize gross income as a result of a cryptocurrency airdrop if the taxpayer receives units of new cryptocurrency? Airdrops are means of distributing units of a cryptocurrency to multiple taxpayers.**
  - A taxpayer has ordinary gross income under section 61 as a result of an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of the new cryptocurrency.

In some cases, firms might be preparing taxes for somebody who works as a cryptocurrency miner or converter. According to IRS guidance:

- Any taxpayer who receives cryptocurrency for their efforts realizes gross income upon receipt of that currency. These efforts can include actual mining or maintaining the blockchain ledger.
- The FMV of the currency on that day is includible in income.
- The same rules regarding self-employment tax and expenses apply to anyone compensated for their auto-generation work where they are not an employee of another business.
  - The rules also affect third parties that settle payments between merchants and their customers (known as third-party settlement organizations [TPSOs]). If the number of transactions settled exceeds 200, and the gross amount exceeds $20,000, these organizations must report payments made to merchants on a Form 1099-K, Payment Card and Third-Party Network Transactions.

Power definitions

- **Airdrop:**[7] A marketing stunt that involves sending coins or tokens to wallet addresses to promote awareness of a new virtual currency.
- **Block explorer:**[8] A tool people use to view all cryptocurrency transactions online.
- **Hard fork:**[9] A radical change to a network's protocol that makes previously invalid blocks and transactions valid, or vice-versa. A hard fork requires all nodes or users to upgrade to the latest version of the protocol software.
- **Zero Knowledge Proof:**[10] A digital protocol that allows for data to be shared between two parties without using a password or any other information associated with the transaction.

How CPAs can help: Advisory

Firms can move beyond tax implications to advise clients on the business opportunities and risks associated with cryptocurrency. The complexity of blockchain and cryptocurrency essentially combines all the hard work of investment advice with an evolving market and regulatory landscape.

In this advisory role, firms can offer a solid action plan that:

- Helps clients evaluate options
- Guides clients through adoption or implementation
- Identifies critical controls and metrics that can illuminate success and ensure compliance

Firms looking to offer advisory services must become experts in the market. This means understanding the currencies themselves and the business ecosystem built around them. How are large businesses and other adopters settling their cryptocurrency transactions? What platforms are emerging, and how do they specialize? What does a typical implementation roadmap involve?

Since payment platforms will drive the growth in cryptocurrency adoption, advisers should become familiar with that space and be able to help clients evaluate their options. Understanding adoption trends can also help firm clients evaluate what peers are doing in similar markets.

Professionals need to understand cryptocurrency market basics and be up to date on available investment vehicles. They must steer their clients into reputable currency and exchanges and help these clients understand the tax ramifications when making investment decisions.

Businesses looking to accept cryptocurrency need advisory help considering their options. Companies can build their own mechanisms for receiving currency or leverage an off-the-shelf solution. CPA firms should acquire this knowledge — a mixture of technical, tax, and finance expertise — to help businesses evaluate these two options and proceed with confidence.

Firms need to be able to advise clients about two primary challenges to accepting cryptocurrency:

- How is the payment actually made for companies looking to receive cryptocurrency?
- Once received, are funds stored in cryptocurrency or immediately settled and converted into regular cash? What are the implications of both approaches?

Power definitions

- **Cold storage:**[11] An offline wallet used for storing cryptocurrency. The digital (or cryptocurrency) wallet is stored on a platform that is not connected to the internet, thereby protecting the wallet from unauthorized access, cyber hacks, and other vulnerabilities.
- **Cryptocurrency exchange:**[12] An exchange where users can buy or sell cryptocurrencies using electronic monetary units, fiat currencies, or other digital assets.
- **Cryptocurrency wallet:**[13] An app that allows cryptocurrency users to store and retrieve their digital assets.
- **Decentralized exchange:**[14] A peer-to-peer (p2p) online service that allows direct cryptocurrency transactions between two interested parties.

What the various paths of the advisory process look like

Building cryptocurrency infrastructure from scratch	Using a business wallet	Leveraging a payment processor
Ideal for businesses expecting high-transaction frequency and who have high cryptocurrency expertise	Ideal for businesses expecting low-transaction frequency but who have low expertise	Ideal for businesses expecting high-transaction frequency but have low expertise
This requires a business to build a settlement system that integrates with the blockchain on the front end and a standard finance and revenue system on the back end. Clients will need help gathering technical and business requirements, managing the development process, and moving through to adoption. Firms can be a trusted adviser throughout the process.	This option involves creating a business wallet, which gives businesses the ability to receive cryptocurrency. Funds received still must be settled on the back end. Clients will need help evaluating their wallet options. They'll also need to understand how to settle funds into cash while staying in line with IRS guidance on business reporting.	This means paying a third-party provider to help move currency from payor wallets into the businesses' payment systems. Everything is already built, tested, and secured. Clients will need help evaluating and vetting options to make sure they're choosing a trusted provider. Firms can help clients navigate options and negotiate an attractive partnership for both the client and the provider.

Building cryptocurrency infrastructure from scratch		Using a business wallet		Leveraging a payment processor	
Pros	**Cons**	**Pros**	**Cons**	**Pros**	**Cons**
• Visibility into system behavior • Increased security/ compliance control • Ability to control which crypto-currencies are accepted	• Expensive to build and run • Requires technical knowledge to build and maintain • New currencies and models must be added manually	• Fast to set up • Simple	• Still requires manual settling and reporting • Possibly more complex tax implications	• Faster time to market • Can leverage platform marketing to increase awareness • Worry-free scale and support	• Third-party fees • Less control over how the system works/ settles • Less visibility into security and compliance issues
What kind of advice do they need? • These clients need help weighing pros and cons and considering the total costs of building and maintaining a payment and settlement system.		**What kind of advice do they need?** • These clients need help understanding cryptocurrency wallet options. They also need to understand tax implications of accepting cryptocurrency in this manner.		**What kind of advice do they need?** • These clients need help weighing pros and cons and considering the total costs of building and maintaining a payment and settlement system.	

No matter which path clients choose, there are tax and finance implications. Firms need to help clients create the reporting and documentation required to address these issues at filing.

How CPAs can help: Audit

This is the most difficult service to provide. The private nature of cryptocurrency makes auditing assets and establishing controls difficult. How do you inject trust into an ecosystem built and sustained on being trustless? How can a firm gain visibility? How can auditors build controls into a blockchain that is controlled by a collective?

Then, there is a lack of external regulations. Without guidance from the IRS and other authorities, customers have had little external pressure to demonstrate real visibility and transparency into cryptocurrency holdings. Pressure mainly comes from internal stakeholders and business partners.

Plus, there is a lack of tools. To gain access to cryptocurrency holdings, auditors need specialized tools that can offer visibility into assets without sacrificing the blockchain's core privacy principles. Auditors need to be able to:

- Certify proof of control
- Determine true valuation
- Verify private transactions vs. public blockchain

Firms, thought, will benefit from overcoming these obstacles: 70% of big firm customers expect help with blockchain audits.

Auditing for cryptocurrency requires a deep understanding of the underlying blockchain. Staff must understand how controls — mechanisms of trust — can be built into the blockchain. This is the starting point for the education needed to start reskilling.

To learn the basics of virtual currency, download our white paper, ***"Understanding cryptocurrency: A guide for accountants."***

Conclusion: On becoming a cryptocurrency compliance, advisory, or audit expert

Firms looking to build out their cryptocurrency capabilities need to start by getting educated in the space. This is the critical first step to equipping staff with the knowledge and skills they'll need to help clients embrace the opportunity while always keeping an eye on risk.

Luckily, increased resources are coming online explicitly designed for accounting firms. From industry webinars to CPE materials, the volume of information is growing. Firms should consider which cryptocurrency path — compliance, advisory, or audit — is best suited to their skills and client needs. As competency increases, so can the services and expertise firms can offer.

For tools and resources to expand your cryptocurrency knowledge and to help your clients manage their virtual currency, contact Thomson Reuters® today at 800-968-8900 or visit tax.thomsonreuters.com/en/accounting-solutions.

Here are some resources you might find useful:

Practice Forward

Let us guide you through developing a progressive business model for your firm. With Thomson Reuters Practice Forward content, tools, and guidance, forward-thinking firms can expand into advisory services, improve margins, drive growth, and elevate client service. Learn more.

Onvio Firm Management

Onvio® Firm Management is a comprehensive, cloud-native software that lets you run your accounting practice more collaboratively than ever — from anywhere. Your firm can create the perfect client communication hub by combining document storage with secure online client accounts. Your staff and clients will always stay in sync with centralized data management and real-time updates. Plus, you'll be able to work from anywhere using the convenient mobile apps. Learn more.

UltraTax CS

Thomson Reuters UltraTax CS automates your entire business or individual tax preparation, delivering powerful, timesaving tools. You'll access a full line of federal, state, and local tax programs including 1040 individual, 1120 corporate, 1065 partnership, 1041 estates and trusts, multi-state returns, and more. UltraTax CS seamlessly integrates with other Thomson Reuters solutions, including CS Professional Suite and Onvio cloud software so you never lose any billable hours to manual processing. Meet all of your tax workflow needs with a customized, end-to-end solution built on cloud computing, advanced data sharing, and paperless processing. Learn more.

Checkpoint Edge

Built to deliver the latest in artificial intelligence, cognitive computing, and machine learning technologies, Checkpoint® Edge is a tax and accounting research tool that provides you with a more fluid and intuitive user experience, and enables you to find fast, accurate answers. This means you can you spend less time on tax research and more time doing what really matters most to your business. Learn more.

Cloud Audit Suite

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1 https://www.bankrate.com/glossary/b/blockchain/
2 "Understanding cryptocurrency: A guide for accountants," Thomson Reuters.
3 https://www.investopedia.com/tech/explaining-crypto-cryptocurrency/
4 https://www.investopedia.com/terms/i/initial-coin-offering-ico.asp
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