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Will You Be Paying By Cash, Check, or Bitcoin?

Since the IRS doesn't recognize Bitcoin as a currency, the tax principles that apply to transactions involving it or other virtual currencies are the same that apply to property transactions.

We live in a digital world with a global economy that is increasingly fueled by e-commerce. Many transactions taking place in cyberspace now involve digital or virtual currencies, such as Bitcoin. Yet there's little guidance on how to account for these transactions for tax or regulatory reporting purposes. So we will step outside our comfort zone and offer suggestions.

What Is Bitcoin?

Bitcoin is a decentralized, digital currency that only exists online. People don't have bitcoins in their purse or wallet, and the currency has no government backing. Rather than physically exchanging a tangible piece of currency, an individual simply transfers the appropriate amount into bitcoins from his or her account into another person's or entity's account. This method is similar to what happens when someone uses a debit card, except there's no intermediary to mediate the transaction. The Bitcoin system is able to operate absent a centralized authority by sharing the history of all bitcoin transactions on all computers tied into the Bitcoin Network. Computers on the Bitcoin Network are referred to as miners and are rewarded with bitcoins as they work to maintain the history. A complicated mathematic system prevents the miners from manipulating the history, and secret digital signatures prevent users from stealing others' bitcoin balances.

Virtual currencies have been around for quite some time before Bitcoin, but they always required a third-party mediator. The novelty of Bitcoin is its ability to conduct electronic transactions absent that intermediary. This provides two key advantages over normal bank or credit card transactions. First, the absence of a third party reduces expenses related to transactions. Second, anonymous accounts are created with no personal information attached. The lack of required personal information combined with the Onion Router (a system that allows completely anonymous Internet usage) allows users to create and fulfill contracts while remaining completely anonymous.

The anonymity has resulted in bitcoins being used for drug trades, tax evasion, money laundering, and even contract killings. Most of these illegal activities took place through sites like the Silk Road, a website that operated similarly to Amazon.com, except it involved illegal activities. The FBI eventually shut the website down and confiscated the owner's bitcoins (amounting to around $80 million).

Despite the increased liberty afforded by the new currency, it isn't without disadvantages. Perhaps the largest disadvantage is that the lack of an intermediary means there's no one to call if the transaction fails for any reason. Though Bitcoin isn't backed by any governmental body, many Bitcoin advocates count as favorable this absence of a centralized entity that maintains the power to influence supply and demand. Indeed, Bitcoin is a currency in which anyone who has a computer and access to the Internet may participate. Its value depends solely on what people are willing to do to acquire it.

Bitcoin has been the center of FBI investigations, graced the front page of *The Wall Street Journal*, and fascinated investors and programmers alike. In May 2010, the first documented use of bitcoins to purchase a tangible good occurred when someone traded

10,000 bitcoins for two Papa John's pizzas. Three and a half years later, the value of a single bitcoin was worth more than $1,000. The market capitalization of bitcoins reached a high of $13.9 billion on December 4, 2013. Stories of rapid wealth accumulation not only fascinated dreamers and investors, but also caught the attention of legislators who were responsible for determining how to account for gains and losses related to bitcoins.

Tax Effects of Bitcoins

In its 2013 Annual Report to Congress, the Taxpayer Advocate Service (TAS) bemoaned the lack of guidance by the Internal Revenue Service (IRS) regarding the tax treatment of digital currencies. The report noted that "the IRS has not explained how existing rules apply to digital currency transactions," making it difficult for taxpayers to report such transactions properly. The report recommended that the IRS address the following questions:

1. "When will receiving or using digital currency trigger gains and losses?
2. When will these gains and losses be taxed as ordinary income or capital gain?
3. What requirements for information reporting, withholding, backup withholding, and recordkeeping apply to digital currency transactions?
4. When should digital currency holdings be reported on a Report of Foreign Bank and Financial Accounts (FBAR) or Form 8938, *Statement of Specified Foreign Financial Assets*?"

On April 14, 2014, the IRS issued Notice 2014-21 to describe how existing general tax principles apply to virtual currency transactions. While acknowledging that virtual currencies are a medium of exchange, can be held as an investment, and may operate like a "real" currency, the IRS won't recognize them as currency because they don't have legal tender status in any jurisdiction and aren't backed by any country, region, or governmental body.

For federal tax purposes, virtual currencies such as Bitcoin will be treated as property. As such, tax principles that apply to property transactions will apply to virtual currency transactions. Notice 2014-21 comes in the form of questions and answers. In general, the Notice states that a taxpayer receiving virtual currency (hereafter referred to as bitcoins) as payment for goods or services would recognize income equivalent to the fair market value of the bitcoins. That fair market value then becomes the basis of the bitcoins. If the bitcoins are later exchanged for other property, the taxpayer may have a gain or loss equal to the fair market value of property received less the adjusted basis of the bitcoins.

Since bitcoins are property, an exchange of bitcoins for other property or services could then be considered a bartering transaction, with gains and/or losses recognized currently. This leads to the question of the character of the gain or loss. A reading of Notice 2014-21 clearly shows that a capital gain or loss would only result if the bitcoins were a capital asset in the hands of the taxpayer. Capital assets typically are investment property. Bitcoins used in a trade or business are ordinary assets, and gains or losses would be ordinary.

Those who "mine" bitcoins have self-employment income equal to the fair market value of the bitcoin on the date of receipt. Bitcoins received as payment by independent contractors for services rendered also constitute self-employment income. Income received in the form of bitcoins is subject to employment tax as well as income tax whether the taxpayer is self-employed or an employee. Payments made with bitcoins are subject to the same information reporting requirements as any other payments made in property. Therefore, W-2s and 1099s may be due. Payments made with bitcoins are also subject to the rules on backup withholding.

While Notice 2014-21 addressed the issues cited by the TAS, it didn't address FBAR, instead referring the reader to FIN-2013-G001, "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies." Issued in March 2013, FIN-2013-G001 states that any business that transfers or exchanges virtual currency for real currencies would be considered a money transmitter for registration and reporting purposes under the Bank Secrecy Act. Therefore, Bitcoin payment services and currency exchanges should be regarded as financial institutions for FBAR purposes.

It appears that there's little clear-cut guidance for the treatment of virtual currency for tax and regulatory purposes. Users of

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bitcoins must consider their circumstances carefully to comply with the law and regulations. **SF**

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