The US Federal Taxation of Bitcoins and other Convertible Virtual Currencies

By Christine Lane and Gene Magidenko

Bitcoins burst into the public eye seemingly from nowhere, like Athena emerging from Zeus's brow,[1] and changed the virtual currency paradigm. In 2010 and 2011, Bitcoins traded for well under $1 each. By the beginning of 2013, the virtual currency was trading at $13 per Bitcoin. At their peak in late November and early December 2013, when Bitcoin transactions exceeded 90,000 daily, Bitcoins reached in excess of $1,200 per coin before dropping to their current value of approximately $200.[2]

Notwithstanding investors' ebullience, some countries such as China and Russia have taken more or less hostile stands to this virtual currency.[3] In the United States, the reaction among financial luminaries has ranged from caution (former Federal Reserve System chairman Alan Greenspan: "It's a bubble .... You have to really stretch your imagination to infer what the intrinsic value of Bitcoin is."),[4] to warnings (Berkshire Hathaway chairman Warren Buffett: "Stay away from it. It's a mirage basically."),[5] to outright rancor (Berkshire Hathaway vice chairman Charlie Munger: "I think it's rat poison.").[6] Simultaneously, the US government has taken steps to, if not endorse, then at least acknowledge, Bitcoins. For example, the Federal Election Commission decided recently to allow political contributions in Bitcoins up to $100 per donor, per election cycle.[7]

Yet the dominant sentiment for some time was confusion about how Bitcoins were going to be taxed.[8] Recently, the Internal Revenue Service (IRS) released guidance, Notice 2014-21 (Notice), describing its treatment of Bitcoins for US federal income tax purposes with respect to some taxpayers and several specific scenarios.[9] This article provides a brief background on Bitcoins, discusses the IRS guidance provided in the Notice, and offers observations on the complexities of taxing virtual currencies.

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What Is Bitcoin?

Bitcoin is a virtual payment system that uses a digital currency as a method of exchange, allowing the holder to purchase goods and services as if they were using cash. New Bitcoins are generated by open-source software where users offer their own computing power to verify and record payments into a public ledger by solving complex mathematical problems. Newly minted Bitcoins are rewards created by the Bitcoin system's algorithms for users who process blocks of Bitcoin transactions—this is called "mining."

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Approximately 4,000 new Bitcoins are generated daily, and the current supply is close to 14 million.[10] With time, the number of Bitcoins generated each year will decrease, until the total volume reaches 21 million, which is expected to occur sometime around or before the year 2140. In addition to mining, participants in the Bitcoin network are compensated via transaction fees paid by end-user payors for verifying Bitcoin transactions (similar to transaction fees received by third-party companies that administer credit card payments on behalf of merchants). These transaction fees are optional, but usually increase the speed with which a transaction is processed.

Generally, Bitcoins are linked to a virtual wallet, which requires two encryption keys to unlock and use. Bitcoins are relatively anonymous, as virtual wallets are not easily linked to particular individuals. However, all

Bitcoin transactions are recorded in and cleared through a public ledger, resulting in a permanent and publicly viewable record tracking every single transaction.

Bitcoins have not been recognized by any G20 country as a "real" currency, but are traded on a few online exchanges. There are several Web sites that purport to track Bitcoin exchange rates, basing them on the going rates at online Bitcoin exchanges. Despite the presence and activities of these exchanges, there are no established standards for determining the proper conversion rate. Different exchanges often show different rates, depending on the volume of Bitcoins traded and other such factors.

This article uses "Bitcoin" and "virtual currency" interchangeably, but it should be noted that the Notice applies broadly to any convertible virtual currency.

Notice 2014-21

The IRS Notice treats "convertible virtual currencies" as property for US federal income tax purposes, not currency. The Notice defines virtual currency as a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value. The IRS acknowledges that virtual currency operates as "real" currency with "actual buying power," even though no jurisdiction has granted it legal tender status. Bitcoins are referred to as "convertible virtual currency," which is a currency that has an equivalent value in real currency, including that which is legal tender.

On receipt of Bitcoin, a taxpayer must include the currency's fair market value in gross income, measured in US dollars (USD) as of the date that the virtual currency was received. The amount included in gross income is the taxpayer's basis. On a subsequent disposition of the currency, the taxpayer typically will realize a gain or loss, potentially subject to favorable capital gain rates. If a virtual currency is listed on an exchange where the rate is determined by market forces, that is, by supply and demand, the currency's fair market value may be determined by using the value of the Bitcoin listed on that exchange.

An individual who successfully "mines" Bitcoins must include in gross income the fair market value of the virtual currency as of the date of its receipt. The "miner" is subject to self-employment tax if the mining activity is considered a trade or business. Virtual currency received by an independent contractor in exchange for services performed is likewise treated as income from self-employment. Accordingly, a person who, in the course of a trade or business, makes a payment using virtual currency worth $600 or more in any taxable year to an independent contractor must report that payment on a Form 1099. Similarly, an employer using Bitcoin to compensate employees is subject to employment taxes, as such payment is treated as wage income to the employees.

A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.[11] A person who settles virtual currency payments on behalf of merchants is subject to IRS information reporting under the usual reporting rules.[12]

Observations and Unanswered Questions

Penalties

According to the Notice, taxpayers taking positions inconsistent with the guidance may be subject to penalties. Such penalties could include, among others: accuracy-related, underpayment of tax, and gross valuation misstatement penalties. The IRS has provided no transitional relief on tax penalties with respect to Bitcoins, so mischaracterizing or taking an inconsistent position on a prior year's tax return may subject a taxpayer to penalties for those prior tax years subject to any statute of limitation rules. In many instances, it may be difficult for taxpayers to take corrective action for prior year tax reporting inconsistencies, as doing so may require appraisals and valuations to determine the fair market value on the date of receipt of Bitcoins for transactions already concluded.

Due to the virtual currency's volatility, employers paying employees in Bitcoins arguably are subjecting them to significant risk, as a Bitcoin paid today in compensation may not be worth nearly as much tomorrow or next year.

Accounting Method

The Notice assumes that the taxpayer is on a cash basis accrual method and that the functional currency is denominated in USD. It is unclear how the guidance impacts taxpayers using an accrual method of accounting or a functional currency other than the USD. If Bitcoins are used more frequently in the global marketplace, especially by industry taxpayers on accrual methods of accounting, presumably the IRS will need to issue further guidance addressing how such taxpayers properly account for transactions concluded in Bitcoin.

Bitcoins as Compensation

Bitcoins also are problematic from an employer-employee compensation perspective. Bitcoin payments to employees are treated as wages and subject to employment and income tax withholding. Accordingly, employers must establish a process to impose withholding on Bitcoin payments, which likely will not be too burdensome given that most employers have payroll systems in place. More problematic, however, is that paying wages in property requires the employer to make a cash outlay to the IRS equal to the amount needed for withholding out of the employer's own funds (as the IRS will not accept Bitcoin in lieu of cash to meet employment tax withholding obligations).

On a non-tax point, due to the virtual currency's volatility, employers paying employees in Bitcoins arguably are subjecting them to significant risk, as a Bitcoin paid today in compensation may not be worth nearly as much tomorrow or next year. This drop in value arguably unfairly penalizes the unwary employee. While an employee may benefit on a later disposition from the appreciation in value of Bitcoins received as payment for compensation, the employee will be required to pay the tax due in cash on the gain from the disposition.

Sourcing Rules

Similar to many other taxing jurisdictions, the US tax system contains a complex set of rules designed to identify items of income as either derived from US or non-US sources. It is not uncommon for a person engaged in mining activity to use computer equipment (servers, networks, etc.) physically located in jurisdictions outside the United States. An issue arises in this context about whether the income from mining activity is properly sourced where the miner resides or where the computer equipment is physically located. The issue appears unresolved under current IRS guidance.

Information Reporting on Non-US Accounts

US persons with financial interests in, or signature authority over, a "foreign financial account," including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, exceeding certain thresholds, generally are required to comply with annual information reporting requirements by filing with the IRS a Financial Crimes Enforcement Network (FinCEN) Form 114, Report of Foreign Bank and Financial Accounts (FBAR) (FinCEN Form 114 superseded TD F 90-22.1).

Moreover, similar information reporting is required with respect to "specified foreign financial assets," provided that the total value of all specified foreign financial assets exceeds certain reporting thresholds. "Specified foreign financial assets" include "financial accounts" maintained by a foreign financial institution and—provided assets are held for investment and not held in an account maintained by a financial institution—stock or securities issued by a non-US issuer, any interest in a foreign entity, and financial instruments or contracts the issuer of, or counterparty to, which is a non-US person.

On the one hand, it might be argued that because Bitcoins are treated as non-currency, they should not be subject to FBAR and specified foreign financial asset reporting. On the other hand, "specified foreign financial assets" include property other than currency, and treating virtual wallets as non-foreign financial accounts may trigger abuses.

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Foreign Account Tax Compliance Act

Along similar lines to the points on FBAR and specified foreign financial asset information reporting, the treatment of Bitcoins under the Foreign Account Tax Compliance Act (FATCA) also remains unclear. A key issue is whether virtual wallet providers should be treated as "foreign financial institutions," or "FFIs," which would be the case if Bitcoins were included in the definition of "financial assets" and virtual wallets in the definition of "financial accounts." If Bitcoins are excluded from these definitions, presumably US taxpayers could convert cash into Bitcoins and stash Bitcoins overseas in non-US accounts without any concern that the virtual wallet account would be reported to the US tax authorities and traced back to the US taxpayer.

This capability would appear to be directly the type of situation that the FATCA rules are designed to expose. On December 12, 2014, the IRS issued final rules under Internal Revenue Code Section 6038D, dealing with information reporting with respect to foreign financial assets. The final rules included a request for comments on the proper treatment of virtual currency under Section 6038D.[15]

Notes

1. According to legend, the Greek goddess of wisdom and justice, Athena, emerged from Zeus's head already grown and fully armed.
2. *See http://bitcoincharts.com/charts/.*
3. However, not all countries are ill-disposed. *See* Stephanie Soong Johnston, "News Analysis: The Tax Implications of Bitcoin," 73 *Tax Notes Int'l* 971 (Mar. 17, 2014); *see also* Marcelo Natale, "Brazilian Tax Authorities Issue Guidance on Treatment of Bitcoins," *Tax Analysts*, 2014 WTD 82-9 (Apr. 29, 2014); Erki Uustalu, "Estonian Tax Board Clarifies Tax Treatment of Bitcoin Transactions," *Tax Analysts*, 2014 WTD 64-6 (Apr. 03, 2014). Also, some have exempted private Bitcoin transactions from tax entirely. Stephanie Soong Johnston, "Private Bitcoin Transactions Are Tax Free, Danish Tax Board Rules," *Tax Analysts*, 2014 WTD 69-3 (Apr. 10, 2014). In recent developments, in December 2014, the New York State Department of Taxation and Finance ruled that Bitcoin transactions are not subject to the state's sales taxes, while Australia announced in January 2015 that Bitcoin transactions are subject to the country's goods and services tax. "Bitcoin Transactions Subject to Goods and Services Tax, Australian Tax Office Says," *Bloomberg BNA Tax & Accounting Center*, 09 DTR I-1 (Jan. 13, 2015).
4. Jeff Kearns, "Greenspan Says Bitcoin a Bubble Without Intrinsic Currency Value," *Bloomberg* (Dec. 04, 2013), at *http://www.bloomberg.com/news/articles/2013-12-04/greenspan-says-bitcoin-a-bubble-without-intrinsic-currency-value.*
5. Paul Vigna, "Buffett: 'Stay Away' From Bitcoin," *The Wall Street Journal Money Beat* (Mar. 14, 2014) at *http://blogs.wsj.com/moneybeat/2014/03/14/buffett-stay-away-from-bitcoin/.*
6. "Charlie Munger Compares Bitcoin to Rat Poison," *ValueWalk* (May 06, 2013) at *http://www.valuewalk.com/2013/05/charlie-munger-bitcoin-rat-poison/.*
7. Jennifer Liberto, "Bitcoin OK for Politics, With $100 Limit," *CNNMoney* (May 08, 2014) at *http://money.cnn.com/2014/05/08/technology/bitcoin-politics/.*
8. At least as early as 2012 there already was serious discussion about the tax consequences of Bitcoins. *See* David D. Stewart & Stephanie Soong Johnston, "Digital Currency: A New Worry for Tax Administrators?," 68 *Tax Notes Int'l* 423 (Oct. 29, 2012).
9. This followed repeated requests for tax guidance from commentators and other government agencies. *See, e.g.*, Eric Kroh, "Taxpayer Advocate Urges IRS Guidance on Virtual Currencies," *Tax Analysts*, 2014 WTD 7-3 (Jan. 10, 2014); United States Government Accountability Office, "Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks," GAO-13-516 (May 2013), at *http://www.gao.gov/assets/660/654620.pdf.*
10. *See http://blockchain.info/charts/total-bitcoins.*
11. *See* I.R.C. §§ 6031-6060.
12. *See* I.R.C. § 6050W.
13. Jaime Arora, "Virtual Currency May Be Reportable on FBAR in Future," *Tax Analysts*, 2014 TNT 108-2 (June 05, 2014).
14. *See* Alison Bennett, "IRS Official: Criminal Investigation Division Scrutinizing Use of Virtual Currency," *Bloomberg BNA Tax & Accounting Center*, 92 DTR G-2 (May 12, 2014).
15. "Reporting of Specified Foreign Financial Assets," T.D. 9706, 79 Fed. Reg. 73,817, 73,821 (Dec. 12, 2014) ("The Treasury Department and the IRS are considering the proper treatment of virtual currency under section 6038D and welcome comments on this topic.").