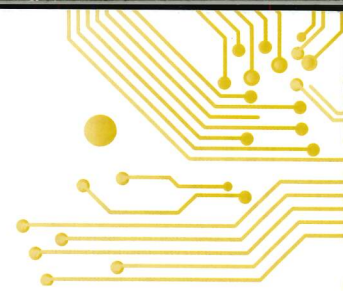


# BITCOIN

A CURRENCY FOR THE DIGITAL AGE

BY BETH LOGAN, EA, AND JOHN DUNDOON, EA





Early 2014 was a fantastic time for Bitcoin proponents. The Sacramento Kings basketball team began accepting bitcoin at their arena. Through donations, the MIT Bitcoin Club gave \$100 worth of bitcoin to every incoming undergraduate at MIT. Microsoft and PayPal began accepting it as payment. Recently, the crisis in Greece gave Bitcoin new life. While the country's banks closed—leaving Greeks little access to euros—bitcoin was still accessible and tradable.

Put simply, digital currency is a virtual representation of perceived value. The economics of supply/demand aside, a currency's value (digital or otherwise) is reflective of our collective trust in its capacity to safely and efficiently serve as a catalyst in facilitating business transactions—like the tulip bulb in 16th Century Holland. Currencies are subject to random fluctuations and even complete collapse. In fact, history shows us that the weakening of a currency's value can indeed rapidly erode in detrimental fashion with seemingly innocuous tipping points.

Outside of the digital currency community, there is still a belief that it is a fad. Whether or not Bitcoin survives is not the issue—digital currency is here to stay in some form. Like all currencies, bitcoin is likely to have future ups and downs. As more people engage in business transactions using digital currencies, tax practitioners will need to remember a basic principle: Digital currency's valuation for income and capital reporting is based on the transaction date in which goods & services were exchanged.

### What Are Digital Currencies?

Before explaining the tax implications, it is important to understand some basics about digital currencies. Currencies like the US dollar, the British pound, the euro, and the Russian ruble are government controlled centralized currencies. These can be traded electronically through banks and other financial institutions or traded via paper and coin currency. Digital/Virtual currencies (also called crypto-currencies) are only traded

electronically. According to mapofcoins.com, nearly seven hundred decentralized digital currencies have been created including Dogecoin and Litecoin. These are often referred to as Altcoins, short for “alternate Bitcoins.” Many Altcoins have gone defunct, but over 200 still exist. In fact, thirty-two new currencies were created in the first four months of 2015. Of these currencies, some have a central control and regulations while others do not.

In March of 2013, the Financial Crimes Enforcement Network (FinCEN) of the US Treasury issued FIN-2013-G001 discussing how regulations are to be applied when taxpayers use digital currencies. According to this guidance, “real” currency is defined as “the coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance.”

“Digital” currency, by definition, operates like paper currency in many environments, but differs in that it does not technically have legal tender status under any jurisdiction. It is not backed by any legal authority other than merely the trust of the people using it. “Convertible” digital currency is a type of digital currency that either has an equivalent value in real currency like US dollars, or acts as a substitute for real currency. Bitcoin falls under this final category.

Bitcoin is decentralized. This means there is no government or organization regulating it. The rules were established when it was initially created and are set in stone. There is actually no person or group that has the power to change it. The rules include using a complicated mathematical function along with public and private keys (passwords) for computer encryption to transact, hence the term “cryptocurrency.”<sup>21</sup>

### What Does Mining Bitcoin Mean?

Digital decentralized currencies require computations to verify the transactions. Since there is no centralized site or organization to handle the computations, a

system of “mining” is established when the currency is formed. “Miners” are owners of computing systems that calculate the mathematical functions in exchange for small payments in the currency. To ensure accuracy and prevent fraud, other miners verify the computations.

### How is the Money Held?

Decentralized digital currencies can be held in “paper wallets,” exchanges, or e-wallets. The latter two are essentially held by a third party for the owner just like a bank holds an account. However, in this case, the owner does not provide his or her name, address, date of birth, or other private information. The owner has a QR code or a long alphanumeric string that represents all the account information. A “paper wallet” is usually the QR code stored on a smartphone. Many Bitcoin experts recommend keeping a paper copy in case something happens to the phone. Without a centralized organization, there is no way to retrieve the money if the QR is lost or damaged. And yes—that means securing a high-tech currency with a low-tech piece of paper.

### What are the Tax Implications?

On March 25, 2014, the IRS released Notice 2014-21 explaining the taxation of bitcoin and other digital currencies. For US federal taxation, digital currencies are treated like property.

Just as income paid in stock is taxable, income paid in digital currency is taxable and subject to withholding and payroll tax. Some miners work for “mining companies.” The companies will have to provide a W-2 to each US employee whether the employee is paid in bitcoin, US dollars, or other property.

If the miner is a contractor to a company, then the company must file a 1099-MISC for all payments over \$600 of bitcoin based on the value at the time of payment. For independent miners, there is no central organization to send a 1099-MISC. The income is still taxable and must be reported.

In addition to earning digital currency

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through mining, an individual or company can buy the currencies. There are bitcoin ATMs (called BTMs) on every continent but Antarctica. Currencies can also be purchased online through trading companies.

The purchasing of property can trigger sales tax but the purchasing of stock or currency does not. Wisconsin,<sup>2</sup> Missouri,<sup>3</sup> and New York<sup>4</sup> do not charge sales tax for the purchase of bitcoin. As of this article's deadline, no other states have ruled on the tax implications of purchasing bitcoin.

Digital currency was designed to be easy to use—until you have to file taxes. Notice 2014-21 states that digital currency must be treated as property. Therefore, each transaction is really a property sale. The taxpayer needs to track the basis at the time of purchase and the date of purchase. The basis at the time of sale is the value in US dollars.

#### Example:

If the seller is trading bitcoin for an Xbox, then the basis could be the cost of the Xbox in US dollars. Assume an Xbox costs \$250 and the current exchange rate for Bitcoin is \$250. Therefore, Microsoft should be accepting one Bitcoin for the Xbox. If the Microsoft shopping site does not update as quickly as other exchanges, the site could read one Bitcoin for the Xbox valued at \$250 while other exchange site claim the value has risen to \$260.

Transaction fees should also be considered just as they are with stock sales. One of the advantages of digital currencies is the reduced transaction fees compared to credit cards and bank transactions. However, there are fees. Some exchanges even have their own fees added to the currency's fees.

The taxpayer has now tracked all purchases and sales of the digital currency. The next step is to calculate gains and determine if they are short or long term. To date, there has been no discussion about the currency's

inventory. Should the taxpayer use FIFO, LIFO, or specific share identification? Considering some discussions in Congress about removal of LIFO and the volatility of digital currencies, it might be best to avoid LIFO. Tracking digital currency is difficult enough without having to time-stamp transactions and assign specific "lots" which do not really exist. The IRS has not spoken but, for the reasons mentioned, most digital currency experts recommend FIFO.

#### Example:

- Chris buys two Bitcoin for \$250/each.
- Chris goes five mornings in a row to a café and purchases a \$2.50 coffee using 0.01 bitcoin. That is five transactions with no gain.
- The next week, Bitcoin is worth \$200. Therefore, each coffee purchase costs 0.0125 bitcoin. Each transaction is a short-term capital loss of \$0.625.
- Chris decides to stop using Bitcoin for coffee. Thirteen months later, Bitcoin rises to \$300. Chris sells the remaining 1.8875 bitcoins for \$566.25 plus a \$2.25 transaction fee. This transaction is a long-term gain of  $((1.8875 * 300) - 2.25) - (1.8875 * 250) = \$92.125$ .

What about wash sales? Bitcoin is not currently considered stock or security and therefore, wash rules should not apply. The IRS could use the non-economic substance transaction rules, which are similar to wash rules. Given the secret nature of digital currency, it is very difficult for the IRS to find and track purchases and sales. Even if they found the transactions, the IRS would have to argue that they were not economic in nature. The taxpayer would also have to be buying the currency as opposed to earning it via mining, payroll, or through product sales.

This issue is similar for centralized digital currencies such as the currency used for online gambling. These are currencies managed and tracked by the company operating

the computer game and are therefore centrally controlled. Active players are earning and spending online "money" each time they play. The money stays in the game until the player cashes part (or all) of the money. These transactions are likely to be less frequent than Bitcoin. For both centralized and decentralized digital currencies, there are currently no concerns about the wash rule and little concern about non-economic substance transaction rules.

What if the taxpayer decides to abandon Bitcoin for Dogecoin? The digital currency community has stated that each digital currency has different rights and characteristics, thus preventing like-kind exchanges. While the community is not a formal group, one would expect the IRS to use community online discussion against the taxpayer. Community members at the MIT Expo on Bitcoin in September of 2014 were strongly in favor of changing the IRS ruling and making Bitcoin a currency. An argument for like-kind exchange supports the IRS view that digital currency is property, so it is unlikely that the community of users will fight for like-kind exchange.

One major conflict that the Department of Treasury has been avoiding is the differing treatments within the department. IRS stated that digital currency was property. FinCEN has stated that trading digital currency meets the definition of money transfer. Therefore, all the companies that administer or exchange the currencies must meet the latest FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML). This is difficult for a currency that prides itself in not having account holders' personal information.

Finally, there is the issue regarding foreign financial holdings. The rules on FBAR and SFFA (Form 8938) have not been established for digital currencies. A general consensus among lawyers, accountants, and EAs that practice in this area is if an account is held in a paper wallet (essentially, on a smartphone), then that

is considered cash in a wallet. An account held in a US exchange is not a foreign account. An account held in a foreign exchange where the exchange has no control over the account should not be considered foreign-held. Without a formal ruling, some practitioners, recommend filing anyway. For a taxpayer with an account in a foreign exchange where the exchange has some control, the FBAR and SFFA rules should be followed until the IRS determines otherwise.

How will the IRS know? They might not, but there are good reasons to disclose. In 2014, Mt. Gox, a Japanese Bitcoin exchange, “lost” millions of bitcoins. If the taxpayer has not been disclosing the foreign account, he probably should not claim the loss on his

taxes. Also in 2014, John Hom lost his case and was penalized \$40,000 for failing to file FBAR on online, foreign poker accounts.<sup>5</sup> The case began with an IRS examination.

There are still many unresolved issues and IRS is accepting comments. The use of digital currencies is increasing enough where it is definitely worth adding, “Do you own any digital currency?” to your annual client questionnaire. **EA**

### About the Author

**Beth Logan, EA**, is the Treasurer of the Massachusetts Society of Enrolled Agents. In addition to taxes, she is a small business consultant. She presents on various tax topics throughout the year. She has about \$1.50 in bitcoin which she acquired to learn about digital currency.

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To learn more about this topic, visit the NAEA Forums.

### ENDNOTES

<sup>1</sup> I have over-simplified the technical aspects of Bitcoin. For a more detailed description, the best I have found is: Chicago Fed Letter, The Federal Reserve Bank of Chicago, December 2013, No. 317.

<sup>2</sup> Wisconsin Department of Revenue, Sales and Use Tax Report, Issues 1-14, March 2014.

<sup>3</sup> Missouri Department of Revenue, Letter Ruling 7411, September 12, 2014.

<sup>4</sup> New York State Department of Taxation and Finance, Technical Memorandum, TSB-M-14(5)C, (7)I, (17)S, December 5, 2014.

<sup>5</sup> *United States v. Hom*, 2014 U.S. Dist. LEXIS 77489 (N.D. CA 2014)

## IRS NOTICE 2014-21: KEY POINTS

1. Digital currency operates like any other currency that circulates as legal tender in exchange for goods or services. However, it is not legal tender.
2. Digital currency is available in various online forms and can be digitally traded or exchanged for other digital currency. It can also be purchased or exchanged for U.S. dollars and other legal tender. The price continuously fluctuates.
3. If you conduct business using digital currency, you must record the value of the digital currency in USD at the end of the business day the transaction occurred for both income and capital gains reporting purposes. This also applies to a third party settlement organization issuing IRS Form 1099-K.
4. The fair-market value of digital currency at the exchange date of goods or services constitutes gross receipts and is subject to ordinary business income tax after subtracting costs of goods sold as well as ordinary, necessary, and reasonable business expenses.
5. Converting digital currency to legal tender is a capital transaction. A capital gain or loss may be incurred upon conversion.
6. Payments made using digital currency are subject to IRS information reporting. If a payment is made of fixed and determinable income using digital currency with a value of \$600 or more to a U.S. tax payer in any given tax year, it is required to report the payment to the IRS and to the payee.
7. Payments of digital currency are required to be reported on IRS Form 1099-MISC and should use the fair-market value of the digital currency in USD as of the payment date or transaction date for goods traded or services rendered.
8. Payments made using digital currency are subject to backup withholding to the same extent as other payments made in property. If you make payments using digital currency, you must solicit a taxpayer identification number (TIN) from the payee.
9. Underpayments attributable to digital currency transactions may be subject to penalties such as accuracy-related penalties under IRC Sec. 6662. In addition, failure to timely or correctly report digital currency transactions when required to do so may be subject to information reporting penalties under IRC Sec. 6721 and 6722.