

Bitcoin Tax Issues

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What is Bitcoin?

- * James White, Director of Tax Issues for the General Accountability Office (GAO), in discussing Bitcoin, has stated that, “Virtual currencies are a digital equivalent of cash. They can be used to buy virtual goods such as within a game,...and can be used to purchase physical goods and services...there are exchanges where you can exchange dollars for Bitcoin and vice versa.” GAO audio interview with Sarah Kaczmarek, June 2013.
- * There are also other virtual currencies that exist, *e.g.*, in Massively Multiplayer Online Role-Playing Games.
- * Also called “digital currencies” or “cryptocurrencies.”

What is Bitcoin?

- * Introduced in 2009 by “Satoshi Nakamoto,” believed to be a pseudonym for a developer or a group of developers.
- * Described by Nakamoto as a peer-to-peer, electronic cash system.
 - * An initial 50 Bitcoin were purportedly “mined” (process described below) by Nakamoto.
 - * There are now over 12,250,000 Bitcoin in circulation.
- * More information can be found here:
<https://bitcoin.org/en/faq>

Purposes of Bitcoin

- * Purposes for creating Bitcoin:
 - * Decentralized system.
 - * Reduce transactional costs.
 - * Safe method for purchasing and selling goods and services.
 - * Provide virtual currency that avoids “double spending”.
 - * Privacy.

Double Spending

- * “Double spending” can occur when two (or more) persons spend the same currency.
 - * Unlike cash currency, each Bitcoin is essentially a unique individual digital code.
 - * Duplication of this code could permit the same Bitcoin to be spent more than once.

Double Spending

- * How does Bitcoin prevent the transfer of a Bitcoin in a transaction from “double spending”?
 - * Every Bitcoin transaction is recorded through the “mining” process.

Bitcoin Mining

- * The mining process occurs when specialized software is used to solve mathematical problems to approve Bitcoin transactions.
 - * This keeps the network secure by verifying and time-stamping the transactions.
 - * This creates a record of the change in ownership of the Bitcoin.
 - * Once a transaction is verified through the mining process, it is essentially irreversible.

Bitcoin Mining

- * Successful miners, who typically participate in a mining pool, receive Bitcoins in exchange for their mining services.

What are Some of the Situations in which Tax Issues Arise with Bitcoin?

- * Obtaining Bitcoin – Mining.
- * Using Bitcoin –
 - * Purchase of Goods or Services.
 - * Investing, Trading or Dealing in Bitcoin.

What are Some of the Tax Issues That Arise with Bitcoin?

- * Timing.
- * Character.
- * Amount of any income/gain/loss/deduction.

What Tax Guidance is Available?

- * The GAO drafted a report on tax compliance issues and virtual currencies.
- * The GAO report noted that the IRS has had a policy group addressing tax issues for virtual economies and virtual currencies used within those economies.
 - * The IRS has set forth some guidance on tax issues in this context.
 - * This guidance does not address Bitcoin.

What Tax Guidance is Available?

- * The IRS is working on tax rules applicable to Bitcoin, but nothing has been published.
- * In January 2014, the National Taxpayer Advocate, Nina Olson, included the taxation of virtual currencies in her report to Congress as an area needing guidance from the IRS.
- * In the absence of specific guidance, where to turn?

What Tax Analysis is Available?

- * There have been numerous articles and conferences in which tax professionals have proposed different theories on how Bitcoin transactions may be taxed.
- * More recently, accountants and attorneys have been authoring more detailed analyses of how Bitcoin may/should be taxed.
 - * Possible treatment: (i) foreign currency, (ii) capital asset, (iii) financial instrument, or (iv) other?

What Other Tax Analysis is Available?

- * Notwithstanding the published views of tax professionals on how Bitcoin should be taxed, anecdotal information indicates that some taxpayers are using the uncertainty to take what appear to be aggressive tax reporting positions.

Is Bitcoin a Foreign Currency?

- * Bitcoin has been called a type of “currency” and is used like a currency.
 - * The Financial Crimes Enforcement Network, or FINCEN, came out with rules for “virtual currency” and these rules cover Bitcoin.
 - * Not tax related.

Is Bitcoin a Foreign Currency?

- * Does Section 988, which addresses certain foreign currency transactions, apply?
- * Section 988(b)(1) provides that foreign currency gain is any gain from a “Section 988 transaction”.
- * Section 988(b)(2) provides that foreign currency loss is any loss from a Section 988 transaction.

Is Bitcoin a Foreign Currency?

- * “Section 988 transactions” include a variety of transactions if the amount that the taxpayer is entitled to receive or to pay is denominated in terms of a “nonfunctional currency” or is determined by reference to the value of one or more nonfunctional currencies.
- * The transactions include debt transactions, accrual of gross items of expense, gross income or receipts, or entering into any forward, futures, option or similar financial instrument.

Is Bitcoin a Foreign Currency?

- * Dispositions of a nonfunctional currency are also defined as Section 988 transactions.
 - * A “nonfunctional currency” includes coin or currency, and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution.
- * Section 988(e) provides a limited exception for certain personal transactions of individuals.

Is Bitcoin a Foreign Currency?

- * So... Is Bitcoin a foreign currency for purposes of these rules?
 - * Some tax commentators have concluded that Bitcoin is not a foreign currency for purposes of Section 988 and that those rules are inapplicable.
- * If not, then how is it taxed?

Is Bitcoin a Capital Asset?

- * Is Bitcoin “property” for purposes of Section 1221?
 - * Section 1221 provides that the term “capital asset” means property held by the taxpayer whether or not held in connection with a trade or business, subject to specified exceptions.
 - * There is also case law on whether or not something qualifies as property under Section 1221.

Is Bitcoin a Financial Instrument or Commodity?

- * Could Bitcoin be treated as a specify type of property that is not a foreign currency?
- * Some commentators have proposed that Bitcoin could be treated as a financial instrument or a commodity (similar to gold, corn, *etc.*).

Bitcoin Investment Tax Disclosure

- * The Winkelvoss twins filed a registration statement with the Securities and Exchange Commission.
 - * The Form S-1 describes an investment trust structure that would effectively permit investors to invest in Bitcoin via an investment in a grantor trust.
 - * The Form S-1 contains a tax disclosure that addresses U.S. investors.
 - * Capital asset treatment is the position to be taken.

Bitcoin Investment Tax Disclosure

- * The Form S-1 notes that alternative characterizations include:
 - * Foreign currency (giving rise to ordinary income/loss).
 - * Financial instrument.

Bitcoin Investment Tax Disclosure

- * The tax disclosure states: “No statutory, judicial or administrative authority directly discusses how Bitcoins should be treated for US federal income tax purposes. As a result, the US federal income tax consequences of investing in Shares are uncertain and alternative characterizations are possible. Accordingly, each Shareholder is urged to consult its tax advisor in determining the tax consequences of investing in Shares in its particular circumstances.”

Methods of Obtaining/Using Bitcoin

- * As noted above, Bitcoin may be obtained in one of several different ways.
 - * Mining.
 - * Purchase/sale for money.
 - * Exchange for goods or services.

Bitcoin Mining

- * Mining involves a person verifying a block in the blockchain for Bitcoin.
 - * This confirms the ownership of the Bitcoin.
- * A number of commentators have suggested that “mining” for Bitcoin and receiving Bitcoin for verifying a block should not be a taxable event.
- * Others have suggested that Bitcoin is a fee for providing the verification service.

Bitcoin Mining

- * If taxable upon receipt, what is the amount of gross income?

Bitcoin Mining

- * Fair market value of Bitcoin.
 - * This FMV could be determined based on trading values for Bitcoin at the time of the receipt.
 - * These “FMV’s” may not be reliable as there are multiple exchanges where Bitcoin can be sold.
 - * There are also reports of failure to receive payment, exchanges where there may not be significant liquidity, *etc.*

Bitcoin Mining

- * Note also that there are deduction/capitalization issues for expenditures related to mining Bitcoin.
- * And, how would the transfer of Bitcoin in exchange for the services of mining be taxed, if at all?

Purchase/Sale of Bitcoin for Cash

- * A purchase of Bitcoin for cash should not be taxable to the purchaser.
- * The purchaser generally would obtain a cost basis in the Bitcoin equal to the amount of cash paid for the Bitcoin.

Purchase/Sale of Bitcoin for Cash

- * A sale of Bitcoin for cash may be taxable to the seller.
- * Gain or loss may be recognized in an amount equal to the difference between the seller's tax basis in the Bitcoin disposed of and the amount realized.

Purchase/Sale of Goods or Services with Bitcoin

- * There are a variety of merchants and others who are willing to accept Bitcoin in exchange for goods and services.
 - * Is the transaction taxable to the payor?
 - * Is the transaction taxable to the recipient?

Purchase/Sale of Goods or Services with Bitcoin - Barter Transactions

- * The exchange of Bitcoin for goods and services may be the same/similar to a barter transaction.
- * Barter transactions are taxable and the IRS has published guidance on barter transactions on its website.
- * Section 1001 would apply to treat the sale or disposition of property as a realization and recognition event, absent some exception.

Purchase/Sale of Goods or Services with Bitcoin - Taxability

- * Is the transaction taxable to the payor of Bitcoin?
 - * Payor of Bitcoin may have gain or loss on the disposition of Bitcoin if the payor's basis in the Bitcoin is less than or greater than their FMV of the date of the disposition.
 - * Anecdotal evidence indicates that some taxpayers take the position that only a disposition of Bitcoin for, *e.g.*, U.S. \$\$ is a taxable event, but a disposition in exchange for goods and services is not a taxable event.

Purchase/Sale of Goods or Services with Bitcoin - Taxability

- * Is the transaction taxable to the recipient?
 - * Amount realized for sale of property or gross income from rendering services in an amount equal to the FMV of the Bitcoin.

Character of Bitcoin Gain or Loss

- * If a holder of Bitcoins recognizes gain or loss on the sale or other disposition of Bitcoins, what is the character?
 - * As noted above, possible characterizations include (i) foreign currency, (ii) capital asset, or (iii) financial instrument or commodity.

Character of Bitcoin Gain or Loss

- * If not foreign currency (ordinary, unless excepted) or a financial instrument or commodity, then generally applicable tax rules would appear to control:
 - * Investor - capital gains and losses.
 - * Trader - capital gains and losses.
 - * Dealer - ordinary income and losses.

Character of Bitcoin Gain or Loss

- * If other characterizations of Bitcoin prevailed, the character of gains and losses could be different.
 - * Foreign currency is generally ordinary income and loss.
 - * Financial instruments and commodities also can be subject to different taxation.
 - * Mark-to-market treatment.

Timing of Bitcoin Gain or Loss

- * When does a holder of Bitcoins recognize gain or loss?
- * Generally applicable tax rules would appear to control:
 - * Investor – realization and recognition.
 - * Trader – realization and recognition.
 - * Dealer – inventory accounting.

Timing of Bitcoin Gain or Loss

- * Special rules that could also apply, depending on tax characterization as security or commodity – Section 475.
 - * Is Bitcoin a security or commodity for these purposes?
 - * Electing trader in securities or commodities - mark-to-market under Section 475(f).
 - * Is the Section 475(f) election available?
 - * Dealer treatment – market-to-market under Section 475(a) (if a security) or Section 475(e) (elective, if a commodity).

Other Tax Issues

- * Cross-border transactions.
- * Tax reporting.
- * What else will come up if/when more taxpayers start filing returns reporting (or not?) Bitcoin transactions?

Other Resources - Bibliography

- * For further reading on Bitcoin – both tax and non-tax – the following articles and links offer additional analysis of Bitcoin-related issues.
 - * Satoshi Nakamoto, “Bitcoin: A Peer-to-Peer Electronic Cash System,” White Paper (2009).
 - * Nikolei M. Kaplanov, “Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against Its Regulation,” *Loyola Consumer Law Review* 25 (2012).
 - * Jerry Brito and Andrea Castillo, “Bitcoin: A Primer for Policymakers,” (2013).
 - * General Accounting Office, “Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks,” GAO-13-516 (May 2013).
 - * https://en.bitcoin.it/wiki/Tax_compliance

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