Bitcoin is property, not currency, IRS says – Notice leaves many open questions about convertible virtual currencies

Global Tax Alert

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The Internal Revenue Service has joined several other jurisdictions in publishing guidance regarding the income tax consequences of certain convertible virtual currency transactions.[i] IRS Notice 2014-21[ii] clarifies that existing general tax principles apply to transactions using convertible virtual currency and that such virtual currencies should be treated as "property" rather than "currency" for US federal income tax purposes. Classification as property may affect the timing and character of income, gain or loss. While the immediate implications of the Notice are apparent, the mid-term and long-term consequences are still being considered. The IRS has indicated that penalties may apply to taxpayers that have taken return positions that are inconsistent with its position in the Notice or that have failed to file the appropriate information returns.

Virtual currency, such as bitcoin, that is "convertible" (i.e., has an equivalent value in or acts as a substitute for "real currency"[iii]) and that is sold or exchanged or used to pay for goods or services in certain transactions **has tax consequences** that may result in a tax liability to the person disposing of such virtual currency and/or receiving such virtual currency.

In addition, **such tax consequences may be immediate or deferred,** and any tax imposed may be **at varying rates**, depending on the nature of the transaction and the type of person disposing of or receiving such virtual currency.

In the following paragraphs, we discuss the Notice and its immediate implications, and we point out some legal, factual and practical issues that the Notice raises.

KEY POINTS

The key points highlighted in the Notice are:

- The receipt of virtual currency in exchange for goods or services **is payment in "property,"** with the fair market value of the virtual currency included in income on receipt and such value becoming the recipient's tax basis in the virtual currency.
- The transfer of virtual currency as payment for services **requires tax reporting** (Form 1099-MISC ordinary income for contractors and Form W-2 wages for employees) and wage withholding required for employee wage payments.
- **"Miners" are treated as financial services providers,** rather than prospectors, receiving compensation for

services at the time of receipt of the virtual currency (rather than a prospector, who would not have income until sale of the discovered treasure).

- **Gain or loss** on the sale of virtual currency is gain or loss from the sale or exchange of property, treated in a manner similar to the sale or exchange of securities. If held as investment property, the gain or loss on sale will be capital gain or capital loss. This treatment is different from the treatment of currency gains or losses, which are ordinary not capital.
- **Penalties may be imposed** for taxpayers taking positions contrary to those specified in the Notice or failing to comply with applicable reporting obligations.

THE NOTICE AND ITS IMMEDIATE IMPLICATIONS

Notice is limited in scope

As a preliminary matter, it is important to note that the Notice only addresses the US federal income tax consequences of *convertible* virtual currency transactions and not any other types of virtual currency transactions.

Whether the IRS will release further guidance with respect to virtual currencies that fall outside the scope of what it has defined as convertible virtual currencies is unclear at this time. In addition, **because the Notice is not a regulatory action, it is not open public comment**;[iv] instead, the Notice represents a public pronouncement containing the IRS's view of the application of *existing* tax law. While the Notice does invite public comment, it only does so with respect to "other types or aspects of virtual currency transactions that should be addressed in future guidance" and that are "not addressed in this [N]otice."

Property, not currency

The Notice clarifies that the IRS will treat bitcoin and other convertible virtual currencies like property, such as stocks and securities, and not as currency. This means that a taxpayer who receives virtual currency as payment for goods or services must include in gross income **the fair market value of the virtual currency, measured in US dollars**, as of the date that the virtual currency was received.[v]

The taxpayer will have a tax basis in such currency equal to the fair market value of the virtual currency in US dollars as of the date of receipt. According to the notice, the fair market value of a convertible virtual currency, if such currency is listed on an "exchange" and the exchange rate is established by "market supply and demand," is determined by converting the virtual currency into US dollars (or into another real currency which in turn can be converted into US dollars) at the exchange rate, in a "reasonable manner" that is "consistently applied." What the IRS considers to be an "exchange," "market supply and demand," a "reasonable manner" and "consistently applied" for these purposes is not clear. **Arbitrage opportunities may exist** if virtual currencies are first converted into non-US currencies and then to the US dollar.

If a taxpayer exchanges virtual currency for other property, the taxpayer generally will have taxable gain if the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency. If the fair market value of the property received is less than the adjusted basis of the virtual currency, the taxpayer has a taxable loss. The character of any gain or loss as ordinary or capital generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

Income characterization of sales and exchanges of virtual currency transactions

As referenced above, the character of a taxable sale or exchange (deferred exchanges are mentioned briefly below) of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Generally, this is good news for a taxpayer that sells virtual currency, held for investment purposes, at a gain and held such currency for more than one year.

A capital asset generally is an asset held for investment purposes, like stocks or bonds or other investment property. Conversely, property held as inventory or other property mainly for sale to customers in a trade or business is not considered a capital asset. The sale or exchange of a capital asset generates capital gain or loss while the sale or exchange of an asset other than a capital asset generates ordinary income or loss.

Currently, long-term capital gains (i.e., gain from the sale or exchange of capital assets held for more than one

year) of non-corporate taxpayers are taxed at lower marginal rates (with a maximum of 20 percent) than ordinary income (with a maximum of 39.6 percent). Short-term capital gains (i.e., gain from the sale or exchange of capital assets held for one year or less) are taxed at ordinary income rates. Capital losses can be netted against capital gains and the excess losses can be deducted from ordinary income (up to US$3,000 each year for individuals). Unused capital losses can be carried forward or backward, subject to limitations, to offset future or past capital gains. A non-corporate taxpayer holding positions in appreciated virtual currencies for more than one year may be able to take advantage of these lower marginal tax rates.

Unlike capital assets, gain or loss from the sale or exchange foreign[vi] currencies (i.e., coin and paper money designated as legal tender that circulates and is customarily used and accepted as a medium of exchange in the country of issuance) is treated as ordinary. Before the Notice, there was a danger that the IRS could have been whipsawed, with investors taking inconsistent positions with respect to virtual currency as a foreign currency for purposes of claiming ordinary losses and as a capital asset for purposes of including capital gains.

Notwithstanding the generally taxpayer friendly position that the IRS has staked out in the Notice, merchants and dealers who accept virtual currencies as a form of payment and who do not immediately convert such currencies into US dollars may themselves be whipsawed. For instance, assume a small business that accepts bitcoins charges a customer US$100 for a widget and the customer pays in the equivalent value in bitcoin. If the value of the bitcoin drops to US$50 in between the time of the merchant's receipt and disposition of the bitcoin, the merchant will have an economic loss of US$50. However, the US$50 economic loss would be a capital loss and would not offset the US$100 ordinary income on the receipt of the bitcoin (unless the bitcoin, in the merchant's hands, was also an ordinary asset). If the merchant cannot use the capital loss to offset other capital gain in the same year, such loss will be suspended and the merchant will suffer a character mismatch. If the merchant has entered into some form of hedging agreement whereby it has downside protection against declines in the value of bitcoin, it is not exactly clear whether such transactions would be treated as ordinary or capital transactions for US federal income tax purposes – thus, a second potential for mismatch occurs (see "Hedging and notional principal contract considerations" below).

Individuals using virtual currencies who are neither dealers nor investors may have an economic loss with no accompanying tax loss upon disposition of virtual currency that has depreciated in value since its acquisition; personal losses are generally non-deductible.

In addition, non-merchant taxpayers who use virtual currencies in personal transactions will have to recognize gain irrespective of the extent of such gain; this is in contrast to foreign currency gain from personal transactions, which is generally excluded if US$200 or less.[vii]

Lastly, any taxable sale or exchange of a virtual currency likely will be **subject to the 3.8 percent tax on unearned income**.[viii] This tax applies to individuals with "modified adjusted gross income" that exceeds certain thresholds (e.g., US$250,000 for married individuals filing jointly, and US$200,000 for single individuals) on the lesser of (i) their net investment income (NII) or (ii) the excess of their "modified adjusted gross income" above the applicable threshold. NII includes net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, other than property held in a trade or business to which the NIIT does not apply,[ix] minus the deductions that are properly allocable to that net gain. Generally, property held for investment would include virtual currencies.

Taxing virtual currency miners

"Mining" is the way bitcoin is issued. To distribute bitcoins, the system creates complex math problems that must be solved by the user's computer.

Mining virtual currency is a taxable event. A taxpayer who mines virtual currency is **subject to tax on receipt based on the fair market value of the virtual currency** at such time. The Notice presumes that the income from mining would be ordinary, and if mining constitutes a trade or business and is not undertaken as an employee, any net earnings (generally, gross income less allowable deductions) constitute self-employment income and are subject to the self-employment tax (i.e., Social Security and Medicare tax).[x]

Employees and independent contractors receiving virtual currencies

All taxpayers who receive virtual currency as compensation for services, whether as an employee or an independent contractor, are **taxed in the same manner as if the amounts paid were US dollars**. Employees who receive virtual currency will be subject to wage withholding and employment taxes.[xi] Independent contractors who receive virtual currency will be liable for income taxes and self-employment taxes. All payment of US taxes must be in US dollars, even if the compensation for services was paid in virtual currency; this can present timing of income issues as well as character mismatch issues if the recipient taxpayer does not immediately convert the virtual currency into US dollars upon receipt.

Information and backup withholding with respect to payments of virtual currency

A payment made using virtual currency is subject to the same information reporting and backup withholding requirements as payments made in US dollars. Thus, a person who, in the course of a trade or business, makes a payment of fixed and determinable income using virtual currency with a value of US$600 or more to a US non-exempt recipient is required to report the payment to the IRS and to the payee on the appropriate 1099 Form.[xii] The payments subject to this information-return requirement are rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits, and income,[xiii] and commissions, fees, interest (including original issue discount), royalties and pensions.[xiv]

Similarly, a person who, in the course of a trade or business, makes a payment of US$600 or more to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC.[xv] Payments of virtual currency required to be reported above should be reported using the fair market value of the virtual currency in US dollars as of the payment date. Payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee and must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required.

Payors making payments subject to these information reporting and backup withholding rules must ensure proper systems are in place in order to comply with the timing requirements for the issuance of the reports and for the proper translation of exchange rate values in order to withhold the correct amounts from payments. As discussed below, penalties may apply for the failure to issue such reports and/or withhold when required by law.

Third-party settlement organizations

The information reporting rules currently applicable to third party settlement organizations (TPSOs) apply to payment processors that settle transactions in virtual currency. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a TPSO.

The most common example of a TPSO is an online auction-payment facilitator, which operates merely as an intermediary between buyer and seller by transferring funds between accounts in settlement of an auction/purchase. A TPSO is required to report payments made to a merchant on Form 1099-K if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds US$20,000. The dollar value of payments denominated in virtual currency is based on the fair market value of the currency on the payment date.

Penalties

As referenced above, the Notice reflects the IRS's view on existing law with respect to transactions in virtual currency. Taxpayers may be subject to penalties for failure to comply with tax laws for past years. The Code imposes penalties on taxpayers, such as accuracy-related penalties[xvi] and penalties for failing to timely or correctly report transactions subject to information reporting.[xvii]

For example, a taxpayer may be subject to penalties for underpayments attributable to virtual currency transactions if, *inter alia*, the taxpayer failed to use the appropriate fair market value to translate the virtual currency into US dollars or failed to report gain on the disposition of virtual currency. Similarly, failure to properly backup withhold may lead to penalties as well.[xviii] Penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.

MID-TERM AND LONG-TERM ISSUES WITH RESPECT TO CONVERTIBLE VIRTUAL CURRENCIES

The following are tax issues that have either been raised in the past with respect to virtual currencies or that the Notice has brought to the forefront. We anticipate that the IRS will need to issue additional guidance and perhaps make conforming revisions to existing Treasury Regulations.

- **PFIC and CFC implications**: Without further modifications, it is not clear whether virtual currencies should constitute passive assets for purposes of the 50 percent asset test applicable to passive foreign investment companies (PFICs). However, income from the sale or exchange of virtual currencies should constitute passive income for purposes of the 75 percent gross income test applicable to PFICs because virtual currencies do not give rise to any income; income from the sale or exchange of virtual currencies should be includable as subpart F income for purposes of the rules applicable to controlled foreign corporations (CFCs) for the same reason.
- **Hedging and notional principal contracts considerations**: A taxpayer hedging the risk of fluctuation in the value of virtual currency that it holds is not guaranteed ordinary income treatment under the specialized tax rules applicable to hedging transactions. In addition, it is not clear whether the tax rules applicable to "notional principal contracts" would apply to swaps or other derivatives the payments on which are calculated by reference to published virtual currency exchange rates because it is not clear they would be considered a "specified index" under such rules.
- **Like-kind exchanges**: The like-kind exchange rules exclude certain property from qualifying for deferral of recognition. This property includes stocks, bonds, notes or other securities or evidences of indebtedness, partnership interests, certificates of trust or beneficial interests, choses in action and foreign currencies; however, it is not clear whether virtual currencies would be excluded from such treatment as well by virtue of inclusion in such list or otherwise.
- **Mark-to-market rules of Sections 465 and 1256**: It is not readily apparent whether a taxpayer who deals or trades in virtual currencies would be able to take advantage of the elective mark-to-market rules that exist for dealers in commodities and traders in securities and commodities. In addition, because a derivative contract with respect to a virtual currency would not be considered a "Section 1256 contract," it would not need to be marked-to-market either.
- **Treatment of mining pools as entities**: Miners who engage in pooled mining might be treated as a partnership or other entity for US federal tax purposes. Special tax rules apply to entities, including ongoing reporting obligations.
- **Potential FATCA exclusions**: It does not appear that virtual currencies are "financial assets" or virtual currency "wallets" are "financial accounts" for purposes of FATCA. Similarly, foreign entities holding virtual currencies do not appear to be "financial institutions" for purposes of FATCA.
- **Potential exclusions from specified foreign financial asset reporting**: The rules applicable to the reporting of "specified foreign financial assets" do not appear to contemplate property such as virtual currencies and, as such, appear outside of the scope of such reporting obligations by US individuals.
- **Charitable contributions of virtual currencies**: Though the Notice indicates virtual currency is property, the IRS should clarify that such treatment also applies in the context of charitable contributions; cash is regarded as intangible personal property for purposes of the charitable deduction rules and money of a bullion or numismatic nature has been ruled in other tax contexts to be tangible personal property and has been treated as such for the charitable tax rules.
- **Foreign tax credit implications**: The IRS should clarify that gains from the sale or exchange of virtual currency will be sourced under the rules applicable to personal property sales and treated the same for purposes of determining a taxpayer's foreign tax credit limitation fraction.
- **Constructive sales and straddles**: The rules applicable to constructive sales (e.g., short sales against the box) do not contemplate such monetization transactions with respect to virtual currencies. In addition, the IRS should clarify whether the rules applicable to straddles apply equally to virtual currencies – it must determine that virtual currency constitutes personal property of a type which is "actively traded."

[i] For example, both the UK and Canada, among other jurisdictions, have announced similar treatment.

[ii] Notice 2014-21, 2014-16 IRB, *available here*.

[iii] The IRS considers real currency to be the coin and paper money of the United States or of any other country that is designated as legal tender, circulates and is customarily used and accepted as a medium of exchange in the country of issuance.

[iv] Generally, regulations are first published as proposed and the public is invited to participate in the rulemaking process, and the IRS often holds public hearings on regulations it has proposed. Based on the rulemaking record and public input, a proposed regulation may be modified or withdrawn, or the agency may proceed with a final rule.

[v] This assumes that the taxpayer uses the cash receipts and disbursements method for tax accounting and not the accrual method of tax accounting. Accrual method taxpayers, generally, are not required to account for an item of income until all the events which determine the fact of the right to income have occurred; this discussion does not focus on the specific impacts of the Notice to accrual taxpayers.

[vi] "Foreign" means any currency other than the taxpayer's functional currency.

[vii] *See* Internal Revenue Code of 1986, as amended, Section 988(e)(2). All Section references are to the Internal Revenue Code.

[viii] *See* Section 1411.

[x] *See* Section 1401.

[xi] Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax must be reported on Form W-2, Wage and Tax Statement in US dollar-equivalents.

[xii] Section 6041(a).

[xiii] *Id.*

[xiv] Treas. Reg. § 1.6041-1(a)(1).

[xv] Section 6041A(a).

[xvi] *See* Section 6662.

[xvii] *See* Section 6721 (penalties for failing to file information returns with IRS) and Section 6722 (penalties for failing to file payee statements with income recipient).

[xviii] Payments that are subject to backup withholding are treated as wages paid by an employer to an employee. Section 3406 (h)(10). Thus, if a payor who fails to deduct and withhold the tax can show that the income tax was paid by the payee, the tax won't be collected from the payor. However, the payor will remain liable for penalties for the failure to deduct and withhold. Section 3402(d).

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FATCA regulations updated but deadlines loom

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