TO COIN A PHRASE:
TAXATION OF BITCOINS AND OTHER CRYPTOCURRENCIES AND INITIAL COIN OFFERINGS ("ICOs")

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I. OVERVIEW.

A. Present at the Creation.

1. I was probably one of the first tax attorneys in the U.S. to become curious, then interested, then fascinated, by the possible tax consequences of what was then an obscure area of the financial world known as Bitcoin.

2. The Bitcoin phenomenon was brought to my attention by one of my students in the BU Grad Tax Program, who wanted to write a paper on the taxation of Bitcoin for my Taxation of Intellectual Property course. I gave him the go-ahead for the paper, and then took his very good first effort[1] and spent a whole lot more time expanding it, probing it, and fulminating and meditating on what I by then found the fascinating issue of "What, exactly, is money?". The article was entitled "Bitcoins: Putting Your Money Where Your Mouse Is." A copy of that somewhat lengthy tome is found attached hereto as Exhibit A.

3. Among other venues, I presented this paper and topic to the Boston Tax Forum, a group of very senior tax professionals in the Boston area, in May 2013, and addressed what was then the fascinating and tantalizing possibility that a Bitcoin might actually be eligible for tax treatment as a "currency" and therefore governed by the interesting and arcane provisions of Code §988. The Bitcoin-as-currency issue is now moot, but the topic at the time was infesting and raised a host of fascinating questions. But on with the show.

B. IRS Notice 2014 – 21: The Bitcoin-as-Widget Paradigm.

1. In early 2014, the IRS issued Notice 2014-21, which pretty much put the kibosh on the treatment of virtual currencies as actual currencies. Instead, the IRS announced that a virtual currency would be treated as "personal property" for U.S. federal income tax purposes, and that therefore the tax principles that apply to property transactions in general also apply to transactions in Bitcoin and other virtual currencies. In effect, the IRS declared that for US federal income tax purposes, a Bitcoin was hence forth a Widget.

2. The impact and tax consequences of IRS Notice 2014-21 were described by me in a rather tongue-and-cheek article entitled, "Property, Currency and Semantics Aside – My Bet Is on Bitcoin," which was published by *Cognoscenti*, the website for WBUR Public Radio in Boston, Massachusetts, in April 2014. That article discussed the history and challenges

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[1] The student was named William Schiffman.

faced by the IRS in the classification property for federal income tax purposes, including the infamous "jojoba bean" controversy in the early 1980s, and viewed the Bitcoin classification as yet another example of the IRS's epistemological wizardry. A copy of that Cognoscenti article (which is still posted on the Cognoscenti website at http://www.wbur.org/cognoscenti/2014/04/04/i-r-s-bitcoin-joseph-b-darby) is attached hereto as Exhibit B.

3. During that same year, I participated on a panel at the ABA Tax Section's Fall 2014 Conference in Denver, Colorado, addressing the topic of virtual currencies, and the panel drew a large and wonderfully curious audience asking the many obvious and not-so-obvious questions about the full implications of Notice 2014-21 and related issues. A copy of the materials prepared for that ABA audience are attached hereto as Exhibit C.

C. <u>Structure of this Outline</u>

1. Section II of this Outline will discuss what might be called "Coin Tax 1.0" which is the tax implications of IRS Notice 2014-21, and explores the consequences of treating virtual currencies (referred to herein after as "Coin", which is a great naming devise because it is cryptic as well as crypto) as property.

2. Section III of this Outline will address what might be called "Coin Tax 2.0," which is the very interesting and indeed tantalizing possibility that Bitcoin is not just a lump of mere "property," but may in fact be a very specific, aristocratic and hoity-toity type of property – it may be corporate stock, it may be a bond or debt instrument, it may be a contract for the performance of future services, or it may be it is something else that goes far beyond tax characterization as a "widget."

3. Section IV of this Outline will address what might be called "Coin 3.0," which is the fascinating recent and on-going developments in the world of "Initial Coin Offerings," or "ICOs." The biggest tax issue for ICOs at the moment is whether selling a virtual currency for cash, property, or another virtual currency is a currently taxable event, or whether it can be deferred through the use of a variety of planning and structuring techniques, including particularly a so-called "Simple Agreement for Future Tokens" or "SAFT."

II. NOTICE 2014-21: TREATING VIRTUAL CURRENCY AS A "WIDGET" -- COIN TAX 1.0

A. <u>Overview.</u>

1. Notice 2014-21 was published using what is proving to be an increasingly popular (for the IRS) format comprised of "Frequently Asked Questions" or "FAQs," with IRS-supplied answers. The Full Text of the 16 FAQs is found on page 7 of Exhibit C.

2. The single biggest decision announced in Notice 2014-21 is the statement that virtual currencies will <u>not</u> be treated as a "currency." Q&A 2. Instead, "virtual currency is treated as property." The series of FAQs go on to explore the tax consequences that followed from that classification ruling, including the fact that the use of Coin as a currency would engender immediate taxation whenever the Coin was exchanged for property or used to pay for

services. The tax consequences described in Notice 2014-21 assumed a relatively narrow tax character of the Coin, which might be described as "Widget Held For Investment" treatment. The IRS guidance focused on the "barter" rules for recognizing and reporting gain where Coin was exchanged for other property, and on the compensatory nature and related income reporting requirements where Coin was "mined" (clearly they were thinking of Bitcoin) by taxpayers or received by taxpayers as property for services, including as wages from an employer or as payment for services as an independent consultant.

3. The IRS guidance pretty much assumed that, given the nature of a virtual currency, a Coin will be held as an investment asset, i.e., as a capital asset. Note that if Coin is in fact being held for investment, any gain from short-term trades will generate short-term capital gain (with little or no federal income tax benefit), the any losses from short-term trades will be short-term capital losses with significant restrictions on tax benefits.

4. However, it seemed very possible even in 2014 (at least to me) that the use of Coin as currency in a business context might actually cause the Coin to be treated as "inventory" of the business. For example, if an auto dealership sells cars for Coin, uses Coin to buy more cars, sells the cars for more Coin, uses Coin to buy more cars, and so forth, it may well be that the business is engaging in a series of "exchanges" and that <u>both</u> the cars <u>and</u> the Coin are in the nature of inventory.

5. Why does this matter? Because if Coin go up and down in value (and that is an understatement of the volatility history), it may be that there is an ordinary loss event (as well as an ordinary income event) each time the Coin are exchanged by a business. Obviously, inventory status would potentially be an advantage for tax purposes in terms of using and netting short-term swings in value. That is actually kind what happens under Code Section 988 for businesses engaged in international transactions that move in and out of foreign currencies.

6. Conversion of Coin into "real" currency is clearly a taxable exchange, generating gain or loss. If the Coin is being converted into U.S. currency, for example, it will trigger gain or loss based on the holder's tax basis of the Coin (generally the "cost" of the Coin as determined under Code Section 1012). All transactions are valued in US dollars at the time they occur, per Notice 2014-21, Q&A 5.

7. If the Coin is used to purchase any other type of property other than currency – whether goods, services or "consideration" of any type or nature -- this will also be a taxable event, and is generally treated for tax purposes as if the taxpayer has entered into a "barter" transaction involving widgets, live chickens, or other property. Payments made with Coin are subject to the same information reporting requirements that apply to other payments made with property, <u>i.e.</u>, barter exchange reporting under Form 1099-B.

8. Although it is entirely possible for a business to issue Coin to employees that "vest" over time (raising very interesting issues under Code §83(b)), Coin paid (without vesting restrictions) to employees in exchange for their services is "compensation" to the employees and will be subject to withholding of employment taxes, including social security taxes. Q&A 11. And, since the IRS takes only US currency in payment of its taxes, the employer will need to pay the withholding amounts using US currency.

9. Similarly, if Coin are paid to an independent contractor for services, the Coin are taxable income to the independent contractor and subject to current income taxation, is generally treated as self-employment income, and is subject to income taxes including the self-employment tax. Q&A 10. On the employer side, if the total payments, including payments using Coin, exceed $600 or more in value, the recipient is an independent contractor, the payor will need to issue a Form 1099-MISC to the payee. Q&A 13 The recipient is legally required to report the income realized even if the recipient does not receive the Form 1099-MISC.

B. <u>Like Kind Exchanges of Currencies</u>.

1. I received a fascinating call recently from a financial advisor in New York whose client had, in 2017, exchanged a large amount of Coins for other categories of Coins. Note that the number of different Coins has become extraordinary.

2. A fascinating argument can be made (under pre-2018 law) that virtual currencies or Coins may be the "like kind" to certain other Coins, depending on the nature and character of each specific Coin in comparison to the other.

3. The question is whether the Coins being exchanged are "like kind." The issue of "kindness", meaning things are the same "kind" for purposes of Code Section 1031, has been both very important and extraordinarily mushy over the many years dating back to 1921, when the first antecedent of Code Section 1031 was introduced into the Code. The IRS provided almost no guidance over the years about "kindness," other than some very curious examples, often involving livestock, vehicles and baseball player contracts. However, one area where the IRS provides a remarkable amount of guidance involved gold, silver, and numismatic coins.

Exchanges of non-currency bullion type coins of one country for non-currency bullion type coins of a second country. Rev. Rul. 76-214. (This means that you can trade Canadian Maple Leafs (one ounce gold coin) for a South African Kruggerrand an or US Eagle.) On the other hand, numismatic coins held for investment are not like-kind with bullion coins held for investment. Rev. Rul. 79-143. Gold bullion held for investment is not like-kind with silver bullion held for investment. Rev. Rul. 82-166. (IRS ruled that "silver and gold are intrinsically different metals and primarily are used in different ways.").

4. Now comes the analogy between gold coins and Coins. Virtual Coins that have no intrinsic value associated with them (i.e., are not convertible into property, services or other rights) may analogized to "real" coins that have only numismatic value – the value is strictly in the eye of the beholder and in the pricing offered in the market place. Thus, a Bitcoin may arguably be 'like kind" to any other Coin that does not have any associated rights to be converted into property, services or other rights characteristics, and simply has the value ascribed by the beholder. Non-currency bullion coins, by contrast (e.g., a Canadian Maple Leaf) are valued based on the price of gold (although not always exactly, curiously enough – the IRS analogy was never exactly waterproof) and so a Coin that is convertible into something else might be like kind to another Coin convertible into the "same something else."

5. Ironically, the biggest problem in arguing that a like-kind exchange has occurred may not be whether the Coins themselves are "like kind," but whether there has been

truly an "exchange." One must get into the very complicated back-office operations of a Coin exchange provider – the customer "exchanges" one Coin for a different Coin, but virtual exchanges may or may not represent a true "exchange" between two parties, but rather may potentially represent a sale of one virtual currency and then use of the proceeds to buy the other virtual currency. It is not likely the "Coin Exchange" itself has qualified as a "Qualified Intermediary" within the meaning of Code Section 1031 for purposes of the specific exchange transaction, so this second element of a valid like-kind exchange transaction that would have to be carefully vetted.

6. NOTE: Changes made to Code Section 1031 effective for 2018 eliminate exchanges of all property other than real estate, so this issue will case to be of real-world importance after the 2017 tax filing season ends.

III. COINS AS MORE INTERESTING AND COMPLICATED PROPERTY THAN JUST WIDGETS – COIN TAX 2.0

A. <u>Overview.</u>

1. An obvious problem with the "widget" tax status conferred on Coin by IRS Notice 2014-21 is that Coins treated as generic "widgets" are always taxable when used in any and every type of transfer transaction.

2. But the Internal Revenue Code is chock-a-block full of special rules governing transfer transactions in which intangible property is issued, acquired, exchanged, contributed or otherwise transferred in transactions that qualify for non-recognition status.

3. Code provisions that immediately come to mind are Code Section 1032 (tax-free issuance of corporate stock by a corporation in exchange for contributions or money or property), Code Section 721 (tax-free issuance of partnership interests by a partnership in exchange for contributions of money or property), Code Section 368 (tax-free reorganizations), Code Section 1031 (like-kind exchanges), and Code Section 1202 (sales of qualified small business stock).

4. Can Coin enjoy non-recognition status by meeting the specialized property definitions under some or all of these specialized Code provisions? The short answer is: Yes! The slightly longer answer is: Keep reading!

B. <u>Corporate Stock.</u>

1. It seems clear that a Coin can be issued by a corporation that will qualify and properly be classified as "equity" in the issuing entity. Such a characterization would not just be important –it would be HUGE.

2. A corporation that issues its "stock" for cash or other property does not recognize gain or loss under Code §1032. This is a crucial forbearance on taxation by the Code because corporate stock would have zero basis and so selling stock would otherwise trigger a large amount of taxable gain but for Code §1032. By contrast, a corporation that "creates" and sells Coin that are merely characterized as "property" in exchange for money will recognize

taxable income or gain immediately. In the first case, the corporation does not have any tax liabilities from raising funds and can use all the cash proceeds for business purposes. In the second case, the raising of capital through the sale of Coin is a taxable event, and so something on the order of 25% of the capital raise may soon be payable in federal and state income taxes.[2]

3. A Coin may be characterized as stock of a corporation if it has specific rights and characteristics normally attributable to stock, including a right to share in corporate profits and distributions, and/or a right to vote.[3]

4. The Securities and Exchange Commission, which has a central interest in whether Coin are "securities" in a financial sense (as opposed to an income tax sense) has concluded that at least some "tokens" or Coin are securities for SEC purposes. See SEC Release No. 81207.

5. The critically important issue is that if a Coin qualifies as "stock," then the issue and sale of Coin is not a tax event under Code §1032. In addition, investors who purchase Coin may be governed by the provisions of Code §351, and, if they meet the other requirements of Code Section 351, may avoid tax on appreciated property transferred in exchange for the Coin – and this is true even if the investor uses other virtual currencies to acquire the Coin being issued. Noted that exchanges of Coin for Coin is very common on the internet.

C. <u>The Partnership Interest</u>.

1. If the Coin is issued by a partnership, and is treated as a partnership interest, then under Code §721, the contribution of property to the partnership in exchange for the Coin will be tax-free both to the partnership and to the partner contributing the applicable property.

2. Similar to the analysis of whether a Coin is stock, the question will be whether the Coin includes rights to share in partnership profits and losses, distributions of partnership property, and voting or other rights as a partner.[4]

3. The "tax free" nature of a partnership contribution transaction would apply to contributions of other virtual currencies as well as any other property contributed to the partnership. Note that it is much easier in general to qualify as tax-free contribution of property under Code §721 than under Code §351 (the latter has more onerous requirements, including specifically the "control" test imported from Code Section 368(c)).

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[2] If the proceeds of the Coin sale are invested in ways that produce losses, the immediate gain may be avoided. However, the wonderful aspect of issuing stock is that the corporation has no gain and takes the proceeds from a stock sale with full basis, so that when it uses the proceeds the deductions and losses can be used to offset future income.

[3] The characteristics of "stock" versus "debt" or "equity" versus "debt" have been studies, restudied and more or less beaten to death in the case law and the tax literature, and suffice it to say that the characterization of intangible rights as "stock" is, at the very least, well-mapped and relatively easy to implement be anyone determined to create a bundle of rights that clearly qualify as stock.

[4] See the immediately preceding footnote, which applies equally to equity interests in a partnership.

4. However, note that any subsequent disposition by the partnership of contributed appreciated property (including other Coin) is likely to result in taxable income or gain being allocated back to the contributing partner under Code §704(c). By contrast, gain recognized on disposition by a corporation generally will not be allocated back to the contributing shareholder.

D. Debt Instrument.

1. If the Coin is characterized as a debt instrument, things can occur that are very interest-ing. (Kind of a pun.)

2. First of all, issuance of a debt instrument by a corporation in exchange for money is not a taxable event to the issuer.[5] Issuance of a debt instrument for property other than money MAY be a purchase under the installment sale rules of Code Section 453.

3. A good question is whether the issuance of debt may be a taxable event triggering gain if, for example, virtual currencies are used to acquire the Coin. However, if the Coin is a debt instrument (or stock), the treatment of the issued security as debt should arguably result in debt treatment rather than taxable exchange treatment.

4. If the debt accrues interest payments (whether in the virtual currency or in an actual currency equivalent), then there should be "interest" that is required to be recognized by the holder and deductible by the issuer, including under the OID rules[6] if no actual current payments are made.

5. Obviously if a Coin is characterized as a debt instrument, there can be cancellation of debt income recognized by the issuer if the debt is ever forgiven or written off.

E. Prepaid Goods and Services.

1. If the payments received for Coin represent prepayment of the right to consume goods and services, (generally provided by the issuer of the Coin), the transaction may be characterized as a prepayment for the applicable goods and services.

2. The tax treatment depends on the accounting method of the issuer, but if the issue does not recognize the prepayment as income for financial accounting purposes, and other requirements are met, the income attributable to the prepaid amount may not be recognized until the following tax year.[7]

3. Obviously, Coin that are transferred in a manner that would be characterized as a barter exchange should report the transactions under Form 1099-B.

[5] When a security is issued by a corporation in exchange for property, no gain or loss is realized, since the corporation is merely acquiring the property in exchange for a debt obligation.

[6] The original issue discount rules of Code Section 1271 et. seq.

[7] See Code Section 451(c).

IV. INITIAL COIN OFFERINGS (ICOs)

A. Overview.

1. In the last few years, various business organizations generally (but not always) engaged in business activities of a technical, software or internet-based nature, have offered Coin as a way to raise the equivalent of business capital through a process called an Initial Coin Offering or (ICO). Most though not all of these businesses can be characterized as "start ups," and the ICO is essentially a mechanism to raise capital in order to fund the business as it develops the core business technology.

2. Coins issued in an ICO can be divided into three broad categories.

a. Currency Coins are cryptocurrency or virtual currency coins, such as Bitcoin or Ethereum, that have no intrinsic value and no right to purchase particular goods or services, and that instead function as a form or "currency" to be used as a medium of exchange.

b. Security Coins are designed to qualify as equity (stock or partnership interest) and therefore eligible to be issued without triggering tax consequences under Code Sections 1032 and 721.

c. Utility Coins are issued by businesses that offer (or anticipate offering) goods and services and the Coin can be used to purchase the applicable goods and services.

3. According to CoinDesk, which tracks initial Coin offerings, there were 43 ICOs in 2016, raising an aggregate of $256 million. That number increased to 343 ICOs in 2017, raising it in excess of $5.4 billion. In 2018, through about mid-year, there had been 92 ICOs raising in excess of $3 billion.

4. The biggest issue in ICOs is whether Coin that is a Currency Coin or Utility Coin can be issued without triggering an immediate taxable event. It is particularly important because a Coin will generally have a tax basis of zero in the hands of the original issuer.

5. One question is whether the transaction can be structured as a "deposit" as opposed to a "pre-payment." Pre-payments are taxable on receipt (subject to a possible deferral for one year under Code Section 451(c)), while deposits are not taxable.

6. The core issue is whether the taxpayer receiving the payment has "complete dominion" over the money. Complete dominion means that transfer is a pre-payment, which absence of complete dominion suggests the existence of a deposit. The essential

characteristic of a deposit is that the party making the payment can request a refund of the deposited amount.[8]

7. Calling a payment a "deposit" is not dispositive. (Another almost-pun.) If a "deposit" is not actually refundable then it is a prepayment and not a deposit.[9]

8. As a structuring device, some issuers have taken the position that the transaction is properly characterized as a "pre-paid forward contract". The contracts are sometimes referred to as a Simple Agreement for Future Tokens, or SAFT.

9. The SAFT is structured such that the Coin issuer received payment and then promised to deliver Coin (tokens) in the future determined by dividing the up-front payment by the final issue price when tokens are offered in the market (typically with a further discount, e.g., at 80% of the initial offering price).

10. The argument is that a SAFT is a pre-paid forward contract, and thus is an open transaction until the final number of tokens has been determined and the tokens delivered.

11. Rev. Rul. 2003-7 and Notice 2008-2 provide IRS guidance on forward contracts and the IRS positions are, frankly, rather positive and favorable to taxpayers.

12. However, a recent case, Estate of McKelvey v. Comm'r, 148 T.C. No. 13 (2017), the US Tax Court observed that the reason certain types of prepaid forward contracts are given "open transaction" treatment is because either the amount realized or the adjusted tax basis need to calculate the gain under Code Section 1001 is not known until the maturity date of the contract. In the case of a SAFT, the issuer knows both the prepaid amount and its tax basis (zero) in the tokens to be delivered, regardless of the number of tokens eventually deliverable at maturity date.

13. In short, the tax status of SAFTs is very interesting and far from certain at this time.

14. An interesting variation is whether the prepayment can be structured as a "loan" that is possible to be repaid in money or property (Coin). A loan convertible to Coin by the lender would very likely be respected as a loan. A loan convertible by the borrower into Coin is a more complicated issue, and will depend on the specific structure of the arrangement to see whether, in fact, it is merely a glorified prepaid forward contract.

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[8] Commissioner v. Indianapolis Power & Light Co., 493 US 203 (1990).

[9] Michaelis Nursery, Inc. v. Commisison, T.C. Memo 1995-143 (deposits received by a nursery that were refundable only if the nursery failed to perform its contractual obligations were taxable on receipt)

EXHIBIT A

Bitcoins: Putting Your Money Where Your Mouse Is

By Joseph B. Darby III[1] and William Schiffman[2]

You are the CFO of a major international corporation, and you have this terrible dilemma: Where the heck are you going to put all your corporate cash, other than under your mattress? The recent Cyprus banking crisis is just the latest reminder of how vulnerable the international banking system remains. For that matter, the U.S. banking crisis and the TARP rescue happened less than five years ago. And then, even if you can identify a bank you fully trust, you still have to decide what currency to hold. The Federal Reserve has been printing dollars (electronically) in massive quantities for almost five years, the European Central Bank has been flooding the market with Euros in a desperate effort to prop up the entire EU monetary system, and even Japan has announced that it will join this "race to the bottom" by devaluing the Yen against other currencies.

And then there's the Bitcoin. The Bitcoin has been described as "digital currency" or "emoney", and it has a number of fascinating characteristics that will be discussed in further detail in a moment. But let's start with the big macro-economic picture: In these economically troubled times, when virtually every major government seems grossly mismanaged and financially shaky, how do you like the idea of a new currency, created by the market place and not controlled by any government or central bank; a currency that, like a form of electronic gold, is going to be difficult to inflate or devalue; and a currency you can easily store electronically in almost any place you want (including on your cell phone or in your

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[2] William Schiffman recently completed his Tax LL.M. at Boston University School of Law in May 2013. Prior to pursuing his graduate tax degree, William received his J.D. degree from Samford University in Birmingham, Alabama in May 2012 and his B.A. in Broadcasting from the University of Alabama at Birmingham in 2009. He has experience advising low income clients on state and federal tax returns and worked as a law clerk for several law firms. Before law school, William worked in sales for one of the largest telecommunications companies in the U.S.

pocket), without having to trust banks or governments, and without having to comply with often-burdensome currency reporting regulations.

The point is that the Bitcoin is the first modern attempt by the marketplace to come up with a market-based solution for the chronic problem of bad currency, bad government, and bad politics. This new currency, invented by and very much a progeny of the internet itself, is a spontaneously popular and powerful idea precisely because, like the internet, it advances elemental human desires to promote personal freedom, financial integrity, and exuberant wealth creation. Is Bitcoin going to be a magic answer to all of these pressing problems? It is far too early to tell…but it sure sounds like a heck of a good idea, and, at the very least, the Bitcoin promises to be the first step down the path to a real and viable internet-based monetary system.

The purpose of this article is to discuss briefly the history of the Bitcoin and the technology that makes if feasible, and then to address some of the fascinating tax and financial issues that arise from the creation of a new non-governmental form of "money."

Bitcoins Explained in 500 Words or Less

Providing a "simple" explanation of Bitcoin technology is no small challenge, because Bitcoins are an immensely complex technological and encryption achievement with staggeringly complex ramifications -- but what the heck, let's give it a shot. Here is "Bitcoins" in 500 words or less:

The Bitcoin (BTC) aspires to be a form of money, and like all fiat (paper) money it has no intrinsic value, other than the fact that some people (a small but rapidly growing cadre) accept it as payment for goods or services. The number of Bitcoins in "circulation" currently is about 11 million, and there is a "hard" ceiling (40 million) on the number of BTC that will ever be issued, which limit will be reached in 2040. Bitcoins are divided into 100 million sub-units (0.00000001) called "satoshis."

Technologically, Bitcoins are an internet-based transaction network that maintains a public ledger. If you have Bitcoins and find a taker, you then log the transaction into the ledger, the equivalent of "X transfers 2 BTC to Y." Y now has 2 BTC on the public ledger and can engage in a transaction with

Z. "Y transfers 1.3 BTC to Z."

Amazingly, the Bitcoin ledger is both fully transparent and totally anonymous. Participants are identified solely by number, and so no one knows who X, Y and Z really are. Anonymity is not perfect – you might guess from the posted ledger transactions who X is – but "X" can have as many personal numbers as he wants, and there are "banks" that will let X transfer Bitcoins to himself, keeping the BTCs while changing the associated number. Nifty.

Maintaining the public ledger is costly and time-consuming, so the Bitcoin system issues new Bitcoins only as a form of payment to people who maintain the ledger. This service is called "mining" for BTC, but it is really payment for ledger maintenance. The ledger is not maintained at a single location, but rather is maintained simultaneously in real time at many global locations, updated continuously by skeptical parties monitoring each other's postings.

Miners obtain BTC transactions from a peer-to-peer broadcast network and then simultaneously compete to extend the ledger by adding a "node," or block of transactions, and the miner who "wins" the competition is paid in BTC. To prevent any one party from dominating the process and posting false transactions (e.g., so X can't give the same 2 BTC to Y and Z), every miner much compete by solving difficult mathematical encryption problems called "proofs of work." There are various protocols used to check whether the "winning" node is accurate, and also protocols for resolving conflicts if two incompatible nodes are posted independently at different internet locations in the highly dispersed ledger. The ledger is tested for six generations of nodes, but then goes hard and is not subject to change after that. The security of the node chain is protected through hash chaining, which makes it very difficult to rewrite the ledger once it goes hard.

The mechanics of building the node chain are fascinating, but the simple take-away is that Bitcoins are tracked on an internationally accessible ledger which is very easy to modify to add new (legitimate) transactions but then is then extremely difficult to alter once it becomes permanent.

<u>Solving the Puzzle of Bitcoin Taxation</u>

One of the fascinating challenges for Bitcoins users is figuring out how the transactions should be treated for US income tax purposes. There are at least two alternative ways that US income tax law might characterize a transaction in which Bitcoins are exchanged for money, goods or services: 1) it could be treated as taxable exchange of property, e.g., in the nature of a barter transaction, in which Bitcoins are treated as property exchanged for other property, or 2) it might be characterized as payment made with a "non-functional" currency (e.g., the equivalent of a transaction engaged in by a US taxpayer in a non-US currency, such as the Yen or Euro). Is the Bitcoin more like an investment asset (e.g., like stocks, bonds, commodities, or possibly gold), or is it more like a medium of currency exchange (e.g., like Euros or Yen)?

A Different Branch of the Treasury Says a Bitcoin is Not a Foreign Currency, but Is Nonetheless Subject to the Bank Secrecy Act.

On March 18, 2013, the Financial Crimes Enforcement Network ("FinCEN"), a branch of the US Treasury, issued formal interpretive guidance [FIN-2013-G001] to clarify the applicability of the regulations implementing the Bank Secrecy Act ("BSA") to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies (of which the Bitcoin is by far the most popular). The guidance states in part as follows:

> A user of virtual currency is not an MSB [Money Services Business] under FinCEN's regulations and therefore is not subject to MSB registration, reporting, and recordkeeping regulations. However, an administrator or exchanger is an MSB under FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition applies to the person. An administrator or exchanger is not a provider or seller of prepaid access, or a dealer in foreign exchange, under FinCEN's regulations.
>
> Currency vs. Virtual Currency
>
> FinCEN's regulations define currency (also referred to as "real" currency) as "the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance."3 In contrast to real currency, "virtual" currency is a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction. This guidance addresses "convertible" virtual currency. This type of virtual currency either has an equivalent value in real currency, or acts as a substitute for real currency.

* * *

Dealers in Foreign Exchange

A person must exchange the currency of two or more countries to be considered a dealer in foreign exchange. Virtual currency does not meet the criteria to be considered "currency" under the BSA, because it is not legal tender. Therefore, a person who accepts real currency in exchange for virtual currency, or vice versa, is not a dealer in foreign exchange under FinCEN's regulations.

The Barter Paradigm.

It is useful to start with an analysis of how various Bitcoin transactions would potentially be taxed under the "Barter Paradigm," which treats the Bitcoin as a type of property being exchanged for other property, similar to a purchase or property using gold or silver coins.

Sale or Exchange Treatment Under Code § 1001.

A transaction involving an exchange of Bitcoins for something else -- $ for Bitcoins, Bitcoins for $, Bitcoins for tangible property or services – should be a sale or exchange transaction under Code § 1001 and the so-called "hair trigger" principles of the Cottage Savings[3] case. In turn, income or gain is recognized currently under Code § 61.[4]

Although few (and possibly zero) employers currently pay employees in Bitcoins, receipt of Bitcoins for services should clearly be within the scope of Code § 83 and thus be considered property received in exchange for services. Significantly, Bitcoin "miners" who receive Bitcoins for successfully updating the public ledge are very likely in this category. [As discussed below, Bitcoin miners may in fact be the winners of a competition, in which case the Bitcoin "prize" is taxable income as well, but under a slightly different tax theory and with different tax consequences. Prizes are reported on Line 21 (Other Income) [See IRS Publication 17, Ch. 12, page 94, for 2012 Returns] and are not subject to SE Tax or FICA Tax.]

3

4 See Joseph B. Darby III, *Barry Bonds' Home Run #756: Could Be a (Tax) Catch*, and case law generally holding that income is realized and generally recognized on any "ascension to wealth" that is not expressly excluded from taxation under the Internal Revenue Code.

Is There Any Argument for Non-Recognition under Code Section 1031?

The starting point under Code Section 1031(a)(1) is that all property can be "exchanged" tax-free under Code § 1031 for "like-kind" property so long as both the relinquished property and the replacement property are "held" for a qualifying use or purpose. Code section 1031(a)(2) then provides specific categories of intangible property that are not eligible for like-kind exchange treatment, which categories are comprised of the following:

This subsection [1031(a)] shall not apply to any exchange of—

(A) stock in trade or other property held primarily for sale[5],

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests, or

(F) choses in action.[6]

None of these categories seems to cover the intangible property rights described by a Bitcoin.

As we will discuss below, the regulations under Code § 988 say that an exchange of a non-functional currency for another non-functional currency is not eligible for like kind –exchange treatment. Reg. Section 1.988-2(a)(1)(ii). This regulation effectively adds another category of excluded property to 1031(a)(2); but the question remains whether a Bitcoin is properly classified as a non-functional currency, and, if not, then it can very probably be exchanged for "like kind" property, at least in theory.

[5] The exclusion encompasses two aspects - A) "Stock in trade," which is property held for sale to customers in the ordinary course of the taxpayers' trade or business resulting in gain taxed as ordinary income and; B) "Property held primarily for sale," which is a much more expansive category of excluded property. The word primarily is viewed as being held "principally" or "of first importance." [Malat v. Riddell, 383 US 569, 5 L. Ed. 2d 154, 86 S. Ct. 244 (1966)]. Generally the IRS considers property held primarily for any disposition as falling into the category of property held primarily for sale. [Rev Rul 75-292, 1975-2 CB 333; Wagnesen v. Comm., 74 TC 653 (1980)]. [JBD3 to edit further]

[6] A chose in action is a right to recover or receive money or other consideration or property, but a chose in action is not considered property in itself. Courts typically look to state law for the definition of a chose in action. [See Miller v. United States, 63-2 USTC & 9606, SD Ind 1963]. The chose in action exclusion is vague due to the difficulty in defining the term itself and it has rarely been used to disallow non-recognition treatment in an exchange. Some major league player contracts have been considered a chose in action and denied exchange treatment. Ltr Rul 8453034; Heltzer v. Comm., TC Memo 1991-404, 62 TCM 518, 537. [JBD3 to edit further]

What is “like-kind” to a Bitcoin? Certainly another Bitcoin -- although Bitcoins, unlike real currencies, do not come in denominations and so a taxpayer would never need to get “change” for a Bitcoin. By contrast, exchanging a 100 Euro bill for ten 10 euro bills is not considered taxable, presumably because it is a like-kind exchange not covered by the Code Section 988 regulations (it is an exchange into the same currency, not a different currency).

Code § 1221 Analysis Applied to a Bitcoin.

Code § 1221(a) states that all property is a capital asset except for eight specific categories listed in Cod Section 1221(a)(1)-(8). All but two involve use of the relevant property in the ordinary course of business.[7]

Two of these eight categories bear at least a brief additional examination: Code Section 1221(a)(1) (whether a Bitcoin could be construed as “inventory,”) and Code Section 1221(a)(3) (whether a Bitcoin is a form of copyrightable property in the hands of the person whose personal efforts created the property).

Tax Character of Gain Where Bitcoins Are Exchanged in a Trade of Business Transaction (expenses deductible under Code § 162).

The first question to pose is whether Bitcoins, if they surge in popularity and in the future are regularly used as a true “virtual currency” for buying and selling other property, might be considered “inventory” of a business. Start with the observation that, in unusual historical circumstances, certain goods or commodities have been used as a form of barter currency. In World War II, for example, US soldiers in France used three things as de facto currency, in the following order of importance: 1) cigarettes, 2) chocolate, 3) nylons. Assume that at a future point in time (maybe even the near future) a small convenience market uses Bitcoins to buy cigarettes, sells the cigarettes for Bitcoins, uses the Bitcoins to buy more cigarettes, etc. Is the inventory of that convenience market the cigarettes, the

[7] Code § 1221(a)(3) and .

Bitcoins – or both? It is an interesting question and perhaps there is no easy or automatic answer. Put it this way: If the Bitcoin is not inventory in that situation, does it necessarily have to be classified as a form of currency? The "in between" answer would appear to be that the Bitcoin is a property being traded almost continuously but nonetheless retaining its character as an investment-type asset, and therefore each exchange presumably generates gain or loss. This would likely result in a long reportable list of short-terms gains and losses in the course of the year.

Code § 1221(a)(3) and Copyrightable Property.

Code Section 1221(a)(3) is the most significant nonbusiness exclusion in the list, and applies to certain copyrightable intellectual property, including literary and artistic compositions.[8] Bitcoins are intangible, and Bitcoin miners technically have a hand in "creating" them, but this process is more akin to following a recipe than to composing a symphony. All Bitcoins are exactly alike, and miners are not creating an original work that would qualify for copyright protection.[9] It is true that, under present case law, software in the hands of an individual whose personal efforts created the software is considered property described in Code Section 1221(a)(3)(A) and therefore an ordinary asset.[10] However, even if the very first Bitcoin (or possibly the underlying software) is copyrighted intellectual property described in Code Section 1221(a)(3)(A), it should only be an ordinary gain asset in the hands of its creator, or on the hands of someone whose tax basis is determined with reference to the original creator's basis.[11] Thus, Bitcoin does not seem to fit easily or comfortably into this exclusion either, since millions of identical Bitcoins are "created" by many diverse parties.

The tentative conclusions are that a Bitcoin might be considered inventory in the hands of a business that turned Bitcoins into a de facto currency, but there is no certainty on that issue, and probably few if any businesses (at the moment) that generate that level of Bitcoin transactions. That may, however, change in the future – and possibly in the near future in at least a few cases.

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[8] 26 U.S.C.A. § 1221 (West)
[9] 17 U.S.C.A. § 102 (West)
[10] *Levy v. C. I. R.*, 64 T.C.M. (CCH) 534 (T.C. 1992)
[11] Code Section 1221(a)(3)(C)

Tax Character Where Bitcoins Are Held for Investment (Expenses Deductible Under Code Section 212)

Based on the preceding discussion of Code Section 1221(a), it seems likely that a Bitcoin purchased for investment purposes should be a capital asset in the hands of the investor, absent an over-ride by Code Section 988. Purchasing a Bitcoin with US currency will not result in taxable gain or loss to a US taxpayer.[12] On the other hand, exchanging a Bitcoin for US currency should be a taxable event, generating capital gain or loss, which will be long-term of short-term depending on the holding period.[13]

Tax Character Where Bitcoins are Used as a De Facto Currency for Purchasing and Selling Personal Assets (Expenses and Losses Not Deductible Under Code Section 262

A significant question to ponder is whether Bitcoins might be considered some kind of "personal asset" subject to disallowance of deductions or losses under Code Section 262. This does not seem likely under the "Barter Paradigm," because a Bitcoin is not the same as a boat, vacation home or sports car – the "personal use" element is hard to identify with respect to the Bitcoin itself. The only reason this question seems worth considering is the fact that Code Section 988(e) disallows losses from personal transactions in a non-functional currency.[FN cross-referencing 988(e) discussion, below.]

Even on carefully and open-minded consideration, it is hard to see how a Bitcoin under the Barter Paradigm is not an asset that qualifies as a capital asset under Code Section 1221(a) and is not similar to an investment-type asset, e.g., gold or silver coins. But there remains a potential practical difference, which is that gold and silver coins, for example, are clearly a popular investment-type asset, and are furthermore classified as "collectibles" and subject to a special 28-percent tax rate under Code Section

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[12] It is an interesting technical discussion whether this is a taxable exchange where the US currency has full tax basis, or whether it is not a taxable transaction at all because of the unique characteristics of money.

[13] Code Section 1222.

1(h)(4) and(5).[14] Bitcoins almost certainly are not a "collectible", but even if they were then both gain or loss would be recognized and reported by the taxpayer (albeit subject to the higher 28-percent tax rate).

The Foreign Currency Paradigm

If the Bitcoin were instead characterized as a form of money, e.g., a "foreign currency," then the tax rules would be significantly different. A US taxpayer is subject to tax on worldwide income. [Section 61], and income is ultimately translated into US dollars and the tax is paid in US dollars. Interestingly, foreign currency is characterized for US income tax purposes as personal property, with a tax basis under Code Section 1012 and results in recognition under Section 1001 each time the foreign currency is used in a sale or exchange. Where a foreign currency is exchanged for another foreign currency, gain or loss is recognized, measured by the FMV of the currencies at the time of the exchange. [Philadelphia Park Amusement Co. v. US, 126 F. Supp. 184 (Ct. C. 1954).]

As noted above, the recent guidance issued by a division of the Department of Treasury asserts that Bitcoin should not be treated as a "real currency,"[15] but that was for non-tax purposes, and there is at least a reasonable possibility that the digital money may be taxed like a foreign currency under IRC § 988, which would generally produce ordinary income and losses to a business, but – distressingly to taxpayers – capital gains and non-deductible losses for non-business transactions.

Code Section 988 is an interesting and complicated (and LONG!) provision, but its principles can be distilled into the following observations:

1. foreign currency is generally treated as a type of property received in an exchange, and

[14] Code Section 408(m) defines collectible as follows:
(A) any work of art,
(B) any rug or antique,
(C) any metal or gem,
(D) any stamp or coin,
(E) any alcoholic beverage, or
(F) any other tangible personal property specified by the Secretary for purposes of this subsection.

[15] FinCEN, FIN-2013-G001, March 18, 2013, *available* at http://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html (Last visited Apr. 2, 2013). As noted above, the US Treasury has already said that a Bitcoin is a "virtual currency" and not a "real currency" for purposes of the Bank Secrecy Act, but then also called it a "convertible virtual currency" and concludes that Bitcoin transactions come within the scope of that act for at least some reporting purposes.

2. Section 988 does not create gain recognition where none otherwise exists, but merely changes the character of the gain to ordinary income and in some cases also changes or identifies the source.

For example, assume a US Dollar and a Euro are exactly equal in value, and a US taxpayer pays $100 to buy 100 E. The Euro then appreciates relative to the Dollar and now equals US$1.20. The US taxpayer then exchanges the 100E back to US currency and receives US $120. This is a taxable event, under both Code Sections 61 and 1001, and USTP has gain recognition of $20. Under Code Section 988, this gain is ordinary.[16]

Code Section 988(a)(1)(A) states the general rule that "any foreign currency gain or loss attributable to a section 988 transaction shall be computed separately and treated as ordinary income or loss (as the case may be). Code Section 988(c)(1)(C) says a disposition of a non-functional currency is a "Section 988 transaction." To the extent provided in regulations, any amount treated as ordinary income under Code Section 988(a)(1) is treated as interest income or expense (as the case may be). Acquisition of a nonfunctional currency does not give rise to exchange gain or loss, but it does establish the tax basis in the non-functional currency for purposes or later determining gain or loss on disposition. Reg. Section 1.988-1(a)(1) and (a)(6), EX. 1 and 2.

NOTE: There are special rules for determining whether the US dollar is the "functional currency" for a US taxpayer, but an individual US taxpayer will generally not be a Qualified Business Unit and therefore will treat the US currency as the functional currency.

Tax Character of Gain or Loss under Code Section 988 for Transactions in a Trade or Business (expenses deductible under Code Section 162).

[16] There is a possibility that a taxpayer can elect out of Code Section 988 and into Code Section 1256 for a "pure" currency investment transaction, but that is subject to uncertainty.

Code Section 988 will treat gain or loss from foreign currency transactions as ordinary income or loss, in the nature of interest income and interest expense. Code Section 988 covers both gains and losses from trading into and out of a foreign currency from actual business operations, e.g., buying inventory with Euros and/or selling the inventory for Euros, and also covers gain or loss occasioned by currency fluctuations between the purchase or sale date and the date when the currency is actually converted back into US currency.

Note: There are special rules under Code Section 988 that allow a taxpayer to elect out of Code Section 988 treatment for certain transactions, and instead such transactions are typically treated as subject to Code Section 1256 instead. These rules are beyond the scope of this article.

Tax Character of Gain or Loss under Code Section 988 for Investment Transactions (expenses deductible under Code Section 212).

Code Section 988(c)(1)(C) treats "any disposition of any nonfunctional currency" as a section 988 transaction, and so this provision basically means that a US taxpayer cannot treat a direct investment in currency as an investment in a capital asset. As noted above, there is presently uncertainty about whether a US taxpayer can elect out of section 988 with respect to a direct investment in currency, but that appears to be at least a possibility at this time.

Tax Character of Gain or Loss under Code Section 988 for Personal Transactions.

Special rules apply under Code Section 988(e) to a transaction enter into by an individual which is a "personal transaction."   In a personal transaction, no gain is recognized by reason of changes in exchange rates after the currency was acquired and before disposition, so long as the gain from currency fluctuations does not exceed $200.   Instead, an individual who spends (exchange) foreign currency in a personal transaction is exempted from recognizing gain on the currency fluctuations unless the gain exceeds $200. 988(e) his rule expressly exempts gain that arises because of fluctuations in the exchange rate while the individual holds the foreign currency. It appears that this $200 limit applies on a transaction by transaction basis, and not on a cumulative annual basis.[17] Losses, meanwhile, are treated as losses from a personal transaction and are generally nondeductible.[18]

A "personal transaction" is any transaction entered into by an individual.[19] except to the extent that expenses properly allocated to the transaction meet the requirements for deductibility as a trade or business expense (other than travel expenses in connection with a business trip)[20] or as an expense for the production of income or for the management, conservation or maintenance of property held for the production of income (but not expenses in connection with the determination, collection or refund of taxes)[21]. Thus, transactions entered into in connection with a business trip are personal transactions.[22]

Foreign Bank Account Reporting (FBAR).

The instructions to Form TD F 90-22.1 contain the following requirements and definitions:

> Who Must File an FBAR. A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year.
>
> Financial Account. A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund (i.e., a fund that is available to the general public with a regular net asset value determination and regular redemptions).

17 [RIA G-7047 – get better citation]
18 Code Section 262. See H.R. Rept No. 105-148, 105th Cong, 1st Sess, p. 526.
19 Code Sec. 988(e)(3).
20 Code Sec. 988(e)(3)(A).
21 Code Sec. 988(e)(3)(B).
22 [Conf Rept No. 1-2-220, 105th Cong, 1st Sess, p. 617].

Comment: On the face of the definition of financial account, it does not look like the mere act of holding Bitcoins should be considered within the reporting requirements.

Form 8938

Who Must File

Unless an exception applies, you must file Form 8938 if you are a specified individual that has an interest in specified foreign financial assets and the value of those assets is more than the applicable reporting threshold.

Specified Foreign Financial Assets

Specified foreign financial assets include the following assets.

Financial accounts maintained by a foreign financial institution.

The following foreign financial assets if they are held for investment and not held in an account maintained by a financial institution:

Stock or securities issued by someone that is not a U.S. person,

Any interest in a foreign entity, and

Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person.

Query: Is there a "counterparty" in a Bitcoin ownership arrangement. Holding Canadian Maple Leafs (gold coins issued by Canada) for example, is not considered a reportable transaction.

Minimum Reporting Thresholds.

$50K/$75K for unmarried individuals, $100K/$150K for married individuals

FATCA

[To be added later]

Net Investment Income Tax

The IRS has announced its present position: It is still thinking about Bitcoins and will get back to everyone later.

While we wait for the IRS to make up its mind, it is clear that the four-year-old electronic medium of exchange does not fit neatly within any of the existing provisions of the Internal Revenue Code (Code). This hybrid property, bearing traits of foreign currencies, securities, and commodities, continues to it grow daily in both value and popularity even if no one can as yet specify its tax character.

Code Section 1221(a) lists eight categories excluded from capital asset treatment; all but two involve use of the relevant property in the ordinary course of business.[23]

It should be noted that capital gains treatment likely would not apply to Bitcoins received by individuals in their capacity as miners. Property received as payment for services rendered is considered wages (and also subject to social security and other wage-based withholding taxes) to the extent the fair market value of the property received is greater than the amount paid for the property.[24] Miners perform the service of facilitating Bitcoin transactions, and thus coins received as payment for these services should be ordinary income.

There is a case from the Third Circuit that could affect Bitcoin tax character. The 2006 *Lattera* case involved taxpayers who sold their rights to lottery winnings in exchange for a lump sum payment.[25] In 1991, George Lattera and Angeline Lattera won the Pennsylvania lottery and became entitled to receive $9.5 million over the course of 26 years, paid in annual installments. Eight years later, they sold their rights to the remaining payments in exchange for a lump-sum $3.4 million and reported it as the “the

[23] 26 U.S.C.A. § 1221 (West)
[24] 26 U.S.C.A. § 83 (West)
[25] *Lattera v. C.I.R.*, 437 F.3d 399, 401 (3d Cir. 2006)

sale of a capital asset held for more than one year."[26] The IRS challenged the tax character of the gain under the substitute for ordinary income doctrine that was created by the 9th Circuit.[27] The test states that a lump sum payment isn't eligible for capital gains treatment when it is, in essence, a substitute for future ordinary income.[28] The Court acknowledged the test, but pointed out a weakness in the test by noting that, "in theory, all capital assets are substitutes for ordinary income."[29] The Third Circuit instead created a "family resemblance" test to determine if the property in question more closely resembled a capital or ordinary income asset.[30] This test looks to the property in question, and if it has more characteristics of a capital asset, it is deemed a capital asset; if it more closely resembles ordinary income, then it is given ordinary income treatment.[31] The family resemblance test has been discussed by the 10th and 11th Circuits in analyzing tax treatment of lump sum lottery winnings, but neither Court has explicitly adopted the family resemblance test; it is not certain whether this analysis would be used with regard to Bitcoin. [32]

<u>What if the IRS Says a Bitcoin in "Money"</u>

If the Bitcoin were instead characterized as a form of money, e.g., a "foreign currency," then the tax rules would be significantly different. A US taxpayer is subject to tax on worldwide income. [Section 61], and income is ultimately translated into US dollars and the tax is paid in US dollars. Interestingly, foreign currency is characterized for US income tax purposes as personal property, with a tax basis under Code Section 1012 and results in recognition under Section 1001 each time the foreign currency is used in a sale or exchange. Where a foreign currency is exchanged for another foreign currency, gain or loss is

[26] *Id.* at 401
[27] *Id.* at 403; See also *United States v. Maginnis*, 356 F.3d 1179, 1182 (9th Cir. 2004).
[28] *Id.*
[29] *Lattera* at 404
[30] *Id.* at 406
[31] *Id.* at 409
[32] *Watkins v. C.I.R.*, 447 F.3d 1269, 1272 (10th Cir. 2006), See also *Womack v. Comm'r of IRS*, 510 F.3d 1295, 1301 (11th Cir. 2007)

recognized, measured by the FMV of the currencies at the time of the exchange. [Philadelphia Park Amusement Co. v. US, 126 F. Supp. 184 (Ct. C. 1954).]

As noted above, the recent guidance issued by a division of the Department of Treasury asserts that Bitcoin should not be treated as a foreign currency, [33] but that was for non-tax purposes, and there is at least a reasonable possibility that the digital money may be taxed like a foreign currency under IRC § 988, which would generally produce ordinary income and losses to a business, but – distressingly to taxpayers – capital gains and non-deductible losses for non-business transactions.

Code Section 988 is an interesting and complicated (and LONG!) provision, but its principles can be distilled into the following observations:

1. foreign currency is generally treated as a type of property received in an exchange, and

2. Section 988 does not create gain recognition where none otherwise exists, but merely changes the character of the gain to ordinary income and in some cases also changes or identifies the source.

For example, assume a US Dollar and a Euro are exactly equal in value, and a US taxpayer pays $100 to buy 100 E. The Euro then appreciates relative to the Dollar and now equals US$1.20. The US taxpayer purchases inventory for 100E, worth US $120. This is a taxable event, under both Code Sections 61 and 1001, and USTP has gain recognition of $20. This transaction is NOT governed by 988 – that provision only covers fluctuations that might occur after a sale and before payment.

Code Section 988 says, that any "foreign currency gain or loss.. shall be computed separately and treated as ordinary income or loss[.]" For an individual US Taxpayer, the US dollar is almost always the "functional currency" (unless an individual operates a business that is a Qualified Business Unit, or QBU). [fn "The dollar shall be the functional currency of—
(i) A taxpayer that is not a QBU (*e.g., an individual*);" Treas. Reg. § 1.985–1(b)(1)]

[33] FinCEN, FIN-2013-G001, March 18, 2013, *available* at http://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html (Last visited Apr. 2, 2013)

Section 988 deals primarily with establishing that when a business benefits from the appreciation of a foreign currency (for example, X billed Y in euros, and by the time X was paid, the EUR/USD had increased). **When a** *business* **benefits from fluctuations in currency during a transaction, then the benefit is taxed as ordinary income. That's basically what Section 988 is saying.** Treasury Regulation 1.988-2(a) clarifies that *normally*, foreign currency gains are treated the same way as disposition of any other property is treated by the Code.

Section 988 is still in play here though (for individuals who use bitcoin as their currency of choice), because Section 988(e)(2) lets me off the hook for transactions where I would realize a "gain" of less than $200.00. I'm going to ignore the fact that the gain is actually measured in dollars and might not be a gain at all. The point is that if I purchase an e-book for $5.00, I don't experience a taxable event ***as long as bitcoin is considered to be a "nonfunctional currency."*** Now. if I purchase a fancy TV or computer with my bitcoins, I might have to pay taxes on the "gain." But what if the gain is over $200? Then the transaction is treated similarly to a barter transaction.

Say, for example, that I bought a guitar at a garage sale for $50, but then I realized that the guitar was worth $900. If I give the guitar to my landlord instead of paying $900 in rent, I am supposed to report that gain of $850 on my tax return (Schedule D) as a "gain from the sale **or other disposition** of property."

With appreciated nonfunctional currency**, the situation is analogous once the gain exceeds $200.**

Here's an example:

For simplicity sake, assume I only got paid one paycheck in bitcoins, and the value of BTC at the time was $30.00. My gross pay was 40 BTC. For income tax purposes, I received employment income in the amount of $1200 (USD), I will report this employment income as **ordinary income** on my tax return. Now, BTC has risen to $90.00 and I got to buy a computer for 30 BTC. My "basis" in each BTC (if I choose to allocate it this way) is $30.00. The computer I am buying is worth $2700.00, and my total basis is $900. The result? I have realized a **capital gain** of $1800. I'll need to report this on **Schedule D** and 8949 as a capital gain.

The cool part is that if the situation were reversed, and I was spending BTC that had decreased in value, **any loss** that I experienced from dabbling in bitcoins **would be nondeductible** under section 165(c).

Ok – but what if the IRS doesn't treat BTC as a currency? Well, then it gets really fun. If BTC is not a currency, then the $200 exemption under 988(e)(2) on recognizing gains from personal use of the BTC does not apply!

<u>FBAR Reporting and FATCA Compliance</u>

Yet another really interesting issue is how a US taxpayer holding, say, $25,000 worth of BTC should report these assets under the FBAR rules. The dilemma is immediately evident: $25,000 in a foreign bank is $25,000 in a foreign bank, but "where" are your $25,000 of BTC? Just as a reminder, the FAQ on FBARs reads as follows:

Q. Who must file an FBAR?

A. Any United States person who has a financial interest in or signature authority or other authority over any financial account in a foreign country, if the aggregate value of **these accounts exceeds $10,000 at any time** during the calendar year.

Tax situs rules for intangible assets generally locate the intangible in the jurisdiction of its owner.

[Wiki says, "the *situs* of intangibles property, including intellectual property such as copyright, trademarks and patents but also goodwill, is where the property is registered, or, if not registered, where the rights to the property can be enforced".]

Situs of Debt instruments. Debt instruments issued by U.S. borrowers (including U.S. corporations and U.S. citizens or residents) are U.S. situs assets for estate tax purposes under the general rule, but are non-U.S. situs under certain special rules, such as, if the debt instrument provides "portfolio interest" (which is the case with practically all publicly traded bonds and debentures). Debt instruments generally are non-U.S. situs intangibles for gift tax purposes. It may be possible to structure personal promissory notes to provide for portfolio interest.

Checks and Wire Transfers. There is incomplete IRS guidance on the situs of transfers of checks and wire transfers from non-U.S. residents to U.S. residents. Informal IRS guidance supports the view that a check drawn by a non-U.S. resident from a foreign bank and paid to a U.S. donee is a non-U.S. situs transfer. This view logically also would extend to a gift by wire transfer from a foreign bank to the account of a U.S. resident at a U.S. bank. But this treatment is not certain.

Likewise, FATCA is based on the rapidly antiquated notion that money actually has a repository location, i.e., US citizens in a foreign bank, or non-US citizens in a US bank.

This may turn in part on how the Bitcoin is characterized. If it is classified as a "currency" then it seems very likely that it will be classified as a "foreign currency" or "non-functional currency." Hard to see the US classifying the Bitcoin as a "US currency," but who knows what might be done for policy reasons. If it is a foreign currency then it would seem to increase the possibility that it will be subject to FBAR reporting and possibly some kind of FATCA compliance.

What is the Taxable Event?

Taxable events in regard to Bitcoin must also be analyzed. Bitcoins were treated as property in the capital gains analysis, so the important taxable events will probably be governed under the rules laid out in the Code for acquisition and disposition of property. These rules also generally govern in exchanges of foreign "nonfunctional" currency, [34] so this section will also cover some tax events relating to dispositions of nonfunctional currency.

Generally, in the Code, not all events require the taxpayer to recognize gain or loss. Merely acquiring Bitcoins in exchange for fiat currency probably would not give rise to gain or loss, but rather

[34] 26 U.S.C.A § 988 (West)

establish an initial cost basis equal to the amount paid for the coin. [35] Tax events with regard to property occur when there is a disposition; a change in value would also likely not be a recognition event.[36]

Gain recognition in exchanges of property for services or other property should also be straightforward. “The amount realized in an exchange of property for other property is the fair market value of the other property received.” [37] Similarly, “the regulations [provide] that if services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income.”[38] Under this rule, Bitcoins paid in exchange for services, as opposed to acquisition in a currency exchange, should be recognized as income in the amount of their fair market value when paid. If services are performed at a stipulated price, the regulations will assume this price is the fair market value.[39]

Converting Bitcoins to U.S. dollars could also qualify as a taxable event, like in foreign currency exchanges.[40] In a currency exchange, the amount realized is measured by the fair market value (in U.S. dollars) of the currency at the time of the exchange. So a U.S. taxpayer who buys one Bitcoin for $50 and holds it until the coin increases in value to $60 before exchanging it again for U.S. dollars will likely recognize $10 of gain ($60 realized minus $50 cost basis in the coin).[41]

Tax, Gas, or Grass

Along with many legitimate uses for Bitcoins, there is also a demand to use anonymous virtual currency for more nefarious purposes. Many sources, including the FBI,[42] have noted the possibility of criminal activity arising from individuals using Bitcoins for money laundering and trafficking illegal

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[35] 26 U.S.C.A. § 1012 (West), see also 26 CFR 1.988-1(a)(ii)
[36] *Taxation of U.S. Persons' Foreign Income, 921-2nd*, Tax Aspects of Foreign Currency [hereinafter “Tax Aspects of Foreign Currency”]
[37] *Tax Aspects of Foreign Currency*, Supra note 27; See also Section 1001(b)
[38] Rev. Rul. *79-24*, 1979-1 C.B. 60 (1979), see also 26 C.F.R. § 1.61–2
[39] *Id*.
[40] 26 U.S.C.A. § 988 (West)
[41] *Tax Aspects of Foreign Currency*, Supra note *27*
[42] Federal Bureau of Investigation, *Bitcoin Virtual Currency: Intelligence Unique Features Present Distinct Challenges for Deterring Illicit Activity*, (April 2012) [hereinafter “FBI on Bitcoin”]

drugs. The currency's anonymity also poses problems for the IRS to enforcement taxes on these exchanges.

Bitcoin is decentralized, so government agencies can't go directly to a source to request information or monitor a specific user's activity, but converting Bitcoins to another currency, or buying Bitcoins through an exchange forces most consumers to use a third party service to facilitate the transaction. Some of the major exchanges require users to provide identifying information according to the "anti-money laundering guidelines," so this may be a step in the direction of assessing taxes.

This isn't a total victory for tax compliance. At least one of the major exchange companies[43] doesn't require customers to provide any information. The largest Bitcoin exchanges operate from outside the US, making it more difficult for the IRS to compel these businesses to give up information about their clients. Further, forcing currency exchange services to report information will be helpful in tracking some Bitcoin use, but users who choose to deal entirely in Bitcoin without converting to a national currency will continue to circumvent this reporting imposition.

The IRS can still use the tools already at its disposal to indirectly detect virtual money. The IRS "Audit Techniques Guide" lists several ways an agent can uncover a taxpayer's use of digital money.[44] Examiners are instructed to analyze bank statements to look for unusual activity, and evidence that the taxpayer's spending is unreasonable compared to his or her reported income.[45]

Conclusion

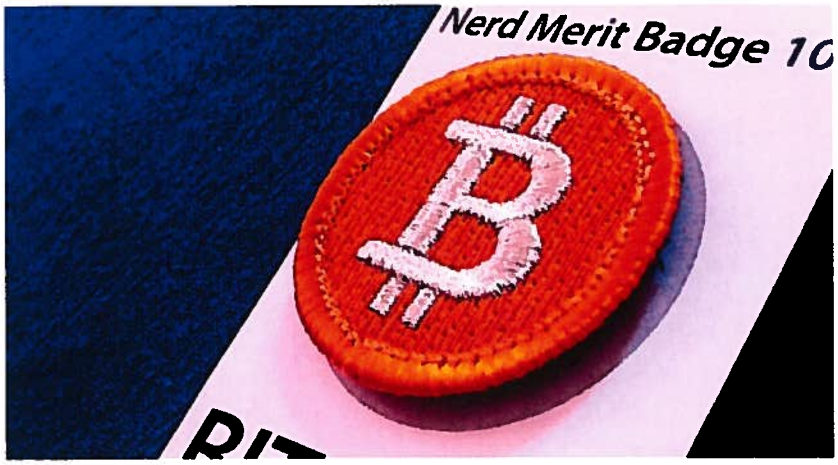
Bitcoin is a complex and controversial new digital currency. It has become notorious for enabling users to anonymously buy anything from pizza to drugs on the internet. This utility has created a high demand and caused the Bitcoin value to skyrocket over a short period of time. The drastic increase in value has even made the coin an investment vehicle for some, albeit a risky one because of its history of

[43] BTCE, btc-e.com
[44] IRS, *Cash Intensive Businesses Audit Techniques Guide - Chapter 7 - Digital Cash and Electronic Money*, *available* at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Cash-Intensive-Businesses-Audit-Techniques-Guide---Chapter-7#digital_07_00 (Last visited Apr. 2, 2013)
[45] *Id*.

volatility. As usual, the law has been slow to follow current events, and there has yet to be any tax guidance for Bitcoin. People around the globe collectively hold the equivalent to over a billion dollars in the electronic medium, so whether Bitcoin continues to boom, or becomes a bubble that bursts, what's certain is that it has already made an impressive impact within its short existence.

EXHIBIT B

Property, Currency And Semantics Aside — My Bet Is On Bitcoin



The Bitcoin has been dealt a blow by the IRS. But that doesn't mean you should count it out. (eagleapex/flickr)

The IRS has a lot on its plate just now: It collects $2-to-3 trillion of revenue each year, administers the tax credit that builds much of the low-income housing in the country, hands out a good chunk of our welfare payments through the Earned Income Tax Credit, and, most recently, runs a goodly portion of the Affordable Care Act, just to mention a few of its more pressing engagements.

But in its spare time the IRS also likes to classify things. For example, back in the 1970s and early 1980s, one of the things the IRS undertook to classify was the jojoba bean. The jojoba is a plant that can grow in semi-arid regions, requires little water or maintenance, and bears, well, that was the question. If the jojoba bean was a "fruit" then it was eligible for valuable agricultural subsidies, but if it was a "nut" then it did not so qualify. After careful consideration and reconsideration — and with lots of thoughtful input from politicians and lobbyists — the IRS reached its solemn verdict: The jojoba bean was both a fruit and a nut. As Casey Stengel used to say, you can look it up.

Building on that epistemological success, the IRS recently turned its attention, in IRS Notice 2014-21, to yet another vexing classification problem: the Bitcoin. Was this strange new internet-based electronic currency a true "currency" or was it a kind of "property"? In other words, was a bitcoin more like a Euro or a dollar, or was it more like a kind of investment property, e.g., stocks, bonds, commodities or a gold bar?

Imagine if you had to keep a record of every time you acquired or spent a dollar, based on daily market variations in the price of a dollar compared to the price of Euros?

The first question you might ask is, "Who the heck cares?"

In fact, the proper tax classification matters a whole lot, at least to Bitcoin owners. If the Bitcoin were classified as a "currency," there would be all kinds of complicated and interesting tax consequences; but if it were classified as "property," all kinds of different, but still complicated and interesting, tax consequences would result.

But enough with the suspense. The envelope please. And the winner, according to the IRS, is: property classification.

By deeming the Bitcoin property, the IRS gives the taxpayers who own Bitcoins some benefits, but takes away others. As property, a Bitcoin held for investment can appreciate or depreciate in value, and therefore will likely result in a long-term capital gain or loss, rather than ordinary income or loss, on disposition. However, if the Bitcoin is used for purposes similar to a currency — which is kind of its whole reason for existing in the first place — this classification is not such a good deal.

The reason is that every transaction involving an exchange of Bitcoins for something else — dollars for Bitcoins, Bitcoins for dollars, Bitcoins for tangible property or services, tangible property or services for Bitcoins, etc. — will be treated as a taxable sale or exchange transaction.

Imagine if you had to keep a record of every time you acquired or spent a dollar, based on daily market variations in the price of a dollar compared to the price of Euros? That is the unmentioned paperwork burden now thrust onto Bitcoin users.

In addition, if you make or lose money in your various Bitcoin exchanges, the tax treatment is complicated. As noted above, if you hold Bitcoins as an investment asset, it should generate capital gain or loss. But if you use Bitcoins as your e-version of cash, any income or gain will certainly be taxable but any loss may in fact be non-deductible. In particular, deductibility of losses may well depend on whether the Bitcoin is being used in personal transactions (possibly making the loss non-deductible) or whether it is being used for business purposes (making the loss at least arguably deductible).

What this all means is that the IRS has made it a real pain in the butt to use Bitcoins as your personal currency.

Whether this ruling is likely to discourage the massive popular proliferation of Bitcoin remains doubtful. The Bitcoin is popular among the propeller heads who drive and populate the internet precisely because it is a digital currency.

Meanwhile, every sensate person should have deep misgivings about almost every form of currency in circulation these days: In case you missed it, the U.S. government has borrowed $6 trillion in just the last five years, and now owes over $16 trillion in debt, with no evident intention of changing its borrowing and spending habits in the foreseeable future. Therefore, despite the overt hostility from all currency-issuing nations — and especially from the United States of America and its Treasury Department — the Bitcoin continues to be curiously and massively popular among a small but extremely sturdy and critically important constituency — tech enthusiasts.

The conventional wisdom is still dismissive of Bitcoins, and tends to view Bitcoin supporters the way the IRS once classified the jojoba bean: as both a fruit and a nut. But we shall see who has the last laugh.

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In short, my money — in whatever currency you wish to wager — is on the Bitcoin.

***Related*:**

- Mark T. Williams: Beware Of Bitcoin
- *On Point*: Digital Currency, Bitcoin And The Dark Web
- What A Bitcoin Political Debut Could Mean For Transparency

The views and opinions expressed in this piece are solely those of the writer and do not in any way reflect the views of WBUR management or its employees.

EXHIBIT C

Bitcoin: Spending Time Thinking about Virtual Currencies

By Joseph B. Darby III, Esq.
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Boston, MA 02109

I. ARTICLE ON BITCOIN PUBLISHED IN *COGNOCENTI*, APRIL 3, 2014.

Property, Currency And Semantics Aside — My Bet Is On Bitcoin
By Joseph B. Darby III, Esq.

http://cognoscenti.wbur.org/2014/04/04/i-r-s-bitcoin-joseph-b-darby#.VABhnWvKqpA.email

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– the Bitcoin continues to be curiously and massively popular among a small but extremely sturdy and critically important constituency: tech enthusiasts.

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II. EARLY DISCUSSION OF TAX DIFFERENCES BETWEEN BITCOIN CLASSIFIED AS PROPERTY V. CURRENCY. [CHART CREATED MAY 6, 2013]

Fish or Fowl?
Commodity or Currency?

Tax Characterization of Bitcoin for US Federal Income Tax Purposes	**Property (Commodity)**	**Foreign Currency**
Purchase a Bitcoin with $	No Tax Consequence	No Tax Consequence
Exchange a Bitcoin for $	Exchange under Code § 1001 and income under Code § 61	Same Exchange Treatment (Code § 988 changes character and sometimes source, but generally not timing, except for special rules such as recognition in an otherwise non-recognition event like a reorganization)
Is the Exchange eligible for Code § 1031?	Bitcoin should be "like kind" with other Bitcoin. Possibly like-kind with other virtual currency? No current answer.	Foreign Currency is excluded from "like kind" treatment under the Regulations under Code § 988
Tax Character Based on Type of Transaction		
Business Transaction (expenses deductible under Code § 162)	Property analyzed under Code § 1221(a); it is at least possible that Bitcoin may be characterized as "inventory" under Code § 1221(a)(1) if a business regularly accepts	Ordinary income is the default treatment, "gain" and "loss" are characterized as interest income and interest expense; There are rules under Code § 988 allowing taxpayers to

	payment in Bitcoin and makes purchases with Bitcoin	elect out of Code § 988 and into Code § 1256 treatment, and it is presently uncertain
Investment Transaction (expenses deductible under Code § 212)	If Bitcoin is held for investment then it will almost certainly be a capital asset under Code § 1221(a) and would generate capital gain and loss.	Code § 988 makes foreign currency not eligible to be treated as an investment asset, so generated ordinary income; but subject to possibility of electing out of Code § 988 and into Code § 1256 status
Personal Transaction (expenses not deductible under Code § 262)	Not entirely clear what a "personal" use of a Bitcoin might be – it is not exactly a boat, vacation home or sports car. Possibly Bitcoin used for personal purchases – i.e., using Bitcoin to BUY a boat, vacation home or sports car. General rule for "personal" assets is to recognize gain but deny a deduction for losses under Code § 262. If using Bitcoin as a *de facto* currency BUT not treated as somehow personal, then a TON of possible gain and loss transactions in immediately prior box; reporting insanity unless there is some kind of *de minimus* rule.	Code § 988(e) provides a pretty good de minimus rule. Treats personal transactions as exempt for gain if under $200 per transaction, and as capital gain if over $200. Losses are not deductible.
FBAR	Where in the world does a Bitcoin exist for FBAR reporting purposes? Although tax nexus and tax sourcing rules are complicated and often idiosyncratic, there is at least a good argument that Bitcoin have tax nexus where the owner resides – i.e., taxed like gain or loss on a sale of stock. That would arguably mean that putting lots of money into Bitcoin avoids	Calling it a "foreign currency" does not create foreign nexus and sourcing automatically, but practically speaking if a Bitcoin is a "foreign currency" then it is a small leap to say that it is also held or maintained in a foreign location. If Bitcoin become valuable, this may be a more fundamental issue than income taxation rules themselves. Bitcoin are

	FBAR reporting requirements. IRS is sure to love that concept.	already “off the grid” in terms of income tax reporting precisely because they are anonymous transactions and the IRS is not yet equipped to track the public ledger (although this second element is easy for any particular individual account number)
FATCA	Same basic issues as FBAR, but perhaps even more encompassing, depending on how FATCA shakes out.	If Bitcoin get big then some kind of FATCA reporting highly likely, and that may lean a little toward “foreign currency” characterization, although it is not absolutely necessary for either FBAR or FATCA for the Bitcoin to be a “foreign” currency so long as it is a “reportable” event.
Net Investment Income Tax (NIIT)	Gain and loss from the sale of investment assets and personal property is subject to the NIIT, so Bitcoin transactions should generally be subject to NIIT. Possibility Bitcoin transactions in the ordinary course of business (rare to date) if frequent enough might be considered inventory sales under Code § 1221(a)(1)) and generate trade or business income not subject to NIIT.	Code § 988 turns gain on currency conversions realized in connection with a business transaction and in connection with an investment transaction into “interest” income. Deemed interest on an “investment” transaction would very likely be subject to NIIT; deemed interest on a business transaction may or may not be subject to NIIT (depending on whether the “interest” is deemed earned on working capital). Personal transactions under 988(e) would likely be capital gain and generate NIIT, but the “N” in NIIT may imply a netting concept that does not occur under Code § 988(e).
Bitcoin Issued for “Mining”	Bitcoin issued for “mining” are simply a form of payment for services, albeit in the form	The tax treatment of the Bitcoin payment – whether characterized as payment for

	of a competition. Whether the Bitcoin are payments or "services" or a "prize" for winning a competition will not change the ordinary character of the income, nor affect its taxability, but it might affect whether certain taxes on "wages" apply. [Is a "prize" in a competition subject to FICA or SECA tax?	services or as a prize for winning a competition -- is the same whether paid in kind or paid in the form of a "foreign currency."
Bitcoin issued by an employer as compensation	FMV of Bitcoin are wages subject to withholding. If employer doesn't withhold from Bitcoin and remit payment in $, the employee can presumably offer payment in $ (e.g., like when an employee exercises an NSO issued by the employer)	Compensation for services can be paid in a foreign currency and retains the tax character of compensation for US income tax and related withholding tax purposes.

III. <u>IRS ANNOUNCES ITS POSITION: BITCOIN IS PROPERTY -- IRS NOTICE 2014-21.</u>

A. <u>Introduction</u>.

On March 25, 2014, the IRS issued IRS Notice 2014-21, providing answers to frequently asked questions (FAQs) on virtual currency, such as bitcoin. These FAQs provide basic information on the U.S. federal tax implications of transactions in, or transactions that use, virtual currency.

The notice provides that virtual currency is treated as property for U.S. federal tax purposes. General tax principles that apply to property transactions apply to transactions using virtual currency. Among other things, this means that:

1. Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes.

2. Payments using virtual currency made to independent contractors and other service providers are taxable and self-employment tax rules generally apply. Normally, payers must issue Form 1099.

3. The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

4. A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.

B. <u>Full Text of 16 FAQs in Notice 2014-21.</u>

SECTION 4. FREQUENTLY ASKED QUESTIONS

Q-1: How is virtual currency treated for federal tax purposes?

A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?

A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.

Q-3: Must a taxpayer who receives virtual currency as payment for goods or services include in computing gross income the fair market value of the virtual currency?

A-3: Yes. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received. See Publication 525, Taxable and Nontaxable Income, for more information on miscellaneous income from exchanges involving property or services.

Q-4: What is the basis of virtual currency received as payment for goods or services in Q&A-3?

A-4: The basis of virtual currency that a taxpayer receives as payment for goods or services in Q&A-3 is the fair market value of the virtual currency in U.S. dollars as of the date of receipt. See Publication 551, Basis of Assets, for more information on the computation of basis when property is received for goods or services.

Q-5: How is the fair market value of virtual currency determined?

A-5: For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.

Q-6: Does a taxpayer have gain or loss upon an exchange of virtual currency for other property?

A-6: Yes. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. See Publication 544, Sales and Other Dispositions of Assets, for information about the tax treatment of sales and exchanges, such as whether a loss is deductible.

Q-7: What type of gain or loss does a taxpayer realize on the sale or exchange of virtual currency?

A-7: The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset. See Publication 544 for more information about capital assets and the character of gain or loss.

Q-8: Does a taxpayer who "mines" virtual currency (for example, uses computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger) realize gross income upon receipt of the virtual currency resulting from those activities?

A-8: Yes, when a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. See Publication 525, Taxable and Nontaxable Income, for more information on taxable income.

Q-9: Is an individual who "mines" virtual currency as a trade or business subject to self-employment tax on the income derived from those activities?

A-9: If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax. See Chapter 10 of Publication 334, Tax Guide for Small Business, for more information on self-employment tax and Publication 535, Business Expenses, for more information on determining whether expenses are from a business activity carried on to make a profit.

Q-10: Does virtual currency received by an independent contractor for performing services constitute self-employment income?

A-10: Yes. Generally, self-employment income includes all gross income derived by an individual from any trade or business carried on by the individual as other than an employee. Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax. See FS-2007-18, April 2007, Business or Hobby? Answer Has Implications for Deductions, for information on determining whether an activity is a business or a hobby.

Q-11: Does virtual currency paid by an employer as remuneration for services constitute wages for employment tax purposes?

A-11: Yes. Generally, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, Wage and Tax Statement. See Publication 15 (Circular E), Employer's Tax Guide, for information on the withholding, depositing, reporting, and paying of employment taxes.

Q-12: Is a payment made using virtual currency subject to information reporting?

A-12: A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, 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 $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities, and compensation.

Q-13: Is a person who in the course of a trade or business makes a payment using virtual currency worth $600 or more to an independent contractor for performing services required to file an information return with the IRS?

A-13: Generally, a person who in the course of a trade or business makes a payment of $600 or more in a taxable year 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, Miscellaneous Income. Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in U.S. dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC. See the Instructions to Form 1099-MISC and the General Instructions for Certain Information Returns for more information. For payments to non-U.S. persons, see Publication 515, Withholding of

Tax on Nonresident Aliens and Foreign Entities.

Q-14: Are payments made using virtual currency subject to backup withholding?

A-14: Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payor 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. See Publication 1281, Backup Withholding for Missing and Incorrect Name/TINs, for more information.

Q-15: Are there IRS information reporting requirements for a person who settles payments made in virtual currency on behalf of merchants that accept virtual currency from their customers?

A-15: Yes, if certain requirements are met. 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 third party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, Payment Card and Third Party Network Transactions, 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 $20,000. When completing Boxes 1, 3, and 5a-1 on the Form 1099-K, transactions where the TPSO settles payments made with virtual currency are aggregated with transactions where the TPSO settles payments made with real currency to determine the total amounts to be reported in those boxes. When determining whether the transactions are reportable, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.
See The Third Party Information Reporting Center, http://www.irs.gov/Tax-Professionals/Third-Party-Reporting-Information-Center, for more information on reporting transactions on Form 1099-K.

Q-16: Will taxpayers be subject to penalties for having treated a virtual currency transaction in a manner that is inconsistent with this notice prior to March 25, 2014?

A-16: Taxpayers may be subject to penalties for failure to comply with tax laws. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under Code § 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under Code § 6721 and 6722. However, 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.

C. Discussion of Notice 2014-21 and Related Tax Issues.

1. Bitcoin is Property Not Currency.

The biggest issue resolved by Notice 2014-21 was the fundamental tax paradigm for using Bitcoin as a form of currency: Bitcoin is treated as property under standard federal income tax principles, rather than as a type of foreign currency under Code §988.

But because Bitcoin will be used – at least by some people – as a *de facto* currency, it raises a number of interesting and unique federal income tax reporting issues.

2. Bitcoin Held for Investment – The Easy Case.

The easiest case to analyze is when Bitcoin held as an investment: The Bitcoin will be characterized a capital asset, similar to an investment in other types of property held for investment.

NOTE: It is tempting to compare Bitcoin held as an investment to a gold coin held for investment, EXCEPT that gold coins are categorized as "collectibles" under Code § 408(m) and are subject to the special capital gains tax rate imposed on collectibles under Code §1.

3. Bitcoin Used in a Trade of Business.

The second alternative is the use of Bitcoin as the "currency" of a person engaged in a trade or business. As discussed below in Section IV, in a mediation written prior to the issuance of Notice 2014-21, it is possible that a business actively engaged in buying and selling inventory using Bitcoin might well be considered to hold Bitcoin as a form of "inventory" as well. For example, assume that Taxpayer X buys and sells property and both accepts and pays with Bitcoin. Although the Bitcoin is being used as a currency surrogate, it is technically trading in property exchanged for other property, and the Bitcoin might well be considered "inventory" of the business. This has the salubrious consequence that gains and losses from the transactions (measured solely in Bitcoin value) are arguably ordinary income and loss, and therefore can be offset in the carrying on of a trade or business.

NOTE: This result would generally mirror the result that a trade of business would experience under Code § 988 if the Bitcoin were characterized as a foreign currency, namely, that gains and losses from currency fluctuations are baked into the overall gain and loss from the business. This would obviously make eminent sense from both a policy and a fairness perspective to businesses that truly uses Bitcoin as a de facto currency (really a unique form of "commodity," based on Notice 2014-21).

4. Bitcoin Used in Personal Transactions.

When Bitcoin are used for personal purchases rather than for business purposes, the complexity – and perplexity – of treating Bitcoin as "property" comes front and center. The personal property purchased by the taxpayer with the Bitcoin is clearly "personal" in nature and subject to characterization under Code § 262, namely, capital gain if sold at a profit and non-deductible loss if later sold at a loss.

But what about the Bitcoin? Does use of Bitcoin for personal purposes mean that the Bitcoin becomes "personal use property" rather than "investment property?" The IRS has not satisfactorily addressed or answered this question.

Logically, if the Bitcoin are analogized to shares of highly liquid stock (or gold coins without the "collectibles" taint), then the taxpayer would arguably have a LOT of transactions involving short-term gain and loss. This is probably reasonable and acceptable to most BTC holders, since the fluctuations in value will tend to cancel out in the aggregate as BTC are used regularly for quasi-currency purposes. Of course, BTC has risen dramatically in value over its existence, albeit in dramatic rises and drops, and so most BTC is "in the money." Substantial losses from BTC would be capital loss and subject to the limitation of being used to offset capital gains plus $3000 per year. Over periods when BTC has stable value, daily fluctuations in value should approximately net out and should not be a major tax detriment. However, if BTC falls in value, the characterization of the loss as capital loss would be a significant tax detriment to most BTC users.

<u>NOTE</u>: In my article written for Cognoscenti, and published in April 2014, I noted that the IRS rule treating Bitcoin as property puts an onerous reporting burden on the use of Bitcoin. But then I spoke to a Bitcoin user, who laughed at my naïveté. "I already have an app on my cellphone to keep track," he assured me.

On the other hand, if Bitcoin used for personal purchases were treated by the as "personal use property" under Code § 262, then gain would be taxable but losses would not be deductible. That result seems palpably unreasonable and unfair. Fortunately, no one – including the IRS – seems to be asserting this position at the moment.

<u>NOTE</u>: Code § 988 deals with this particular complexity by making losses non-deductible, but exempting currency gain transactions from income unless they exceed $200. The fact that §988 treats currency losses incurred in personal transactions as non-deductible raises some concerns that this position might appeal to the IRS. However, §988 also bars treating purchases of foreign currency as an investment in property and instead treats all gain or loss as "ordinary" gain or loss, so §988 is very different from Notice 2014-21. Realistically, the capital gain/capital loss rules are sufficiently biased against taxpayers (due limitations on use of losses) that the IRS should be more than satisfied.

5. Other Consequences of Notice 2014-21.

The rest of Notice 2014-21 is generally logical and even prosaic in its consequences. It requires taxpayers to report gains/losses upon exchange from virtual currency to fiat currency, just as taxpayers must report (albeit under Code § 988 rules) conversions of US dollars to Euros, and back again.

Bitcoin paid for services is treated as compensation income. Thus, miners of Bitcoin must report mined coins at fair market value upon receipt, and a miner's income is subject to self-employment tax. Virtual currency paid as wages is subject to federal income tax withholding. Payments made using virtual currency are subject to information reporting and backup withholding. Taxpayers who fail to comply with Notice 2014-21 are subject to the usual tax-reporting penalties.

IV. LONGER AND EARLIER JEREMIAD ON WHETHER BITCOIN SHOULD BE TAXABLE AS PROPERTY OR CURRENCY [DISTRIBUTED MAY 6, 2013]

Bitcoin: Putting Your Money Where Your Mouse Is

By Joseph B. Darby III[1]

A. Introduction.

You are the CFO of a major international corporation, and you have this terrible dilemma: Where the heck are you going to put all your corporate cash, besides stuff it under your mattress? The international banking system remains shaky and vulnerable. For that matter, the U.S. banking crisis and the TARP rescue happened just six years ago. And -- even if you can identify a bank you fully trust -- you still have to decide what currency to hold. The Federal Reserve has been printing dollars (electronically) in massive quantities for six years, the European Central Bank has been flooding the market with Euros in a desperate effort to prop up the entire EU monetary system, and even Japan has joined this "race to the bottom" by devaluing the Yen against other currencies.

And then there's the Bitcoin. The Bitcoin has been described as "digital currency" or "eMoney," and it has a number of fascinating characteristics that will be discussed in further detail in a moment. But let's start with The Big Picture: In these economically troubled times, when virtually every major government seems grossly mismanaged and financially shaky, how

[1] This article, including the very fun title, was originally inspired by a paper submitted by a student, William "Joey" Schiffman, who completed his Tax LL.M. at Boston University School of Law in May 2013. Mr. Schiffman contributed to the research and drafting of this article and was offered, but declined, recognition as a co-author, indicating that he was happy to be identified as a "contributor," which he most definitely was. Mr. Schiffman is waiting to be admitted to the New York Bar (congratulations, Joey!) and pending admission is currently working at the New York Supreme Court, Appellate Division, First Department.

do you like the idea of a new currency, created by the market place and not controlled by any government or central bank; a currency that, like a form of electronic gold, is going to be difficult to inflate; and a currency you can easily store electronically almost any place you want (including on your cell phone or in your pocket), without having to trust banks or governments?

The point is that the Bitcoin is a serious effort to create a market-based solution for the chronic problem of bad currency, bad government, and bad politics. This new currency, invented by and very much a progeny of the internet itself, is a spontaneously popular and powerful idea precisely because, like the internet, it advances the elemental human desires to promote personal freedom, financial integrity, and exuberant wealth creation. Is Bitcoin going to be a magic answer to all of these pressing problems? It is far too early to tell…but it sure sounds like a heck of a good idea, and, at the very least, the Bitcoin promises to be the first step down the path to a real and viable internet-based "virtual" monetary system.

The purpose of this article is to discuss briefly the history of the Bitcoin and the technology that makes if feasible, and then to address some of the fascinating tax and financial issues that arise from the creation of a new non-governmental form of "money."

B. <u>Bitcoin Explained in 500 Words or Less.</u>

Providing a "simple" explanation of Bitcoin technology is no small challenge, because Bitcoin are an immensely complex technological and encryption achievement with staggeringly complex ramifications -- but what the heck, let's give it a shot. Here is "Bitcoin" in 500 words or less:

The Bitcoin (BTC) aspires to be a form of money, and like all fiat (paper) money it has no intrinsic value, other than the fact that some people (a small but rapidly growing cadre) accept it as payment for goods or services. The number of Bitcoin in "circulation" currently is about 11 million, and there is a "hard" ceiling (21 million) on the number of BTC that will ever be issued, which limit will be reached in 2140. Bitcoin are divided into 100 million sub-units (0.00000001) called "satoshis."

Technologically, Bitcoin are an internet-based transaction network that maintains a public ledger. If you have Bitcoin and find a taker, you then log the transaction into the ledger, the equivalent of "X transfers 2 BTC to Y." Y now has 2 BTC on the public ledger and can engage in a transaction with Z. "Y transfers 1.3 BTC to Z."

Amazingly, the Bitcoin ledger is both fully transparent and totally anonymous. Participants are identified solely by number, and so no one knows who X, Y and Z really are. Anonymity is not perfect – you might guess from the posted ledger transactions who X is – but "X" can have as many personal numbers as he wants, and there are "banks" that will let X transfer Bitcoin to himself, keeping the BTCs while changing the associated number. Nifty.

Maintaining the public ledger is costly and time-consuming, so the Bitcoin system issues new Bitcoin only as a form of payment to people who maintain the ledger. This service is called "mining" for BTC, but it is really payment for ledger maintenance. The ledger is not maintained at a single location, but rather is maintained simultaneously in real time at many global locations, updated continuously by skeptical parties monitoring each other's postings.

Miners obtain BTC transactions from a peer-to-peer broadcast network and then simultaneously compete to extend the ledger by adding a "node," or block of transactions, and the miner who "wins" the competition is paid in BTC. To prevent any one party from dominating the process and posting false transactions (e.g., so X can't give the same 2 BTC to Y and Z), every miner much compete by solving difficult mathematical encryption problems called "proofs of work." There are various protocols used to check whether the "winning" node is accurate, and also protocols for resolving conflicts if two incompatible nodes are posted independently at different internet locations in the highly dispersed ledger. The ledger is tested for six generations of nodes, but then goes hard and is not subject to change after that. The security of the node chain is protected through hash chaining, which makes it very difficult to rewrite the ledger once it goes hard.

The mechanics of building the node chain are fascinating, but the simple take-away is that Bitcoin are tracked on an internationally accessible ledger which is very easy to modify to add new (legitimate) transactions but then is extremely difficult to alter once it becomes permanent.

C. Solving the Puzzle of Bitcoin Taxation.

One of the most fascinating challenges of all for Bitcoin users is figuring out how the transactions should be treated for US income-tax purposes. There are at least two alternative ways that US income tax law might characterize a transaction in which Bitcoin are exchanged for money, goods or services: 1) it could be treated as taxable exchange of property, e.g., in the nature of a barter transaction, in which Bitcoin are treated as property exchanged for other property, or 2) it might be characterized as payment made with a "non-functional" currency (e.g., the equivalent of a transaction engaged in by a US taxpayer in a non-US currency, such as the Yen or Euro). Is the Bitcoin more like an investment asset (e.g., like stocks, bonds, commodities, or possibly gold), or is it more like a medium of currency exchange (e.g., like Euros or Yen)?

D. A Different Branch of the Treasury Says a Bitcoin is Not a Foreign Currency, but Is Nonetheless Subject to the Bank Secrecy Act.

On March 18, 2013, the Financial Crimes Enforcement Network ("FinCEN"), a branch of the US Treasury, issued formal interpretive guidance (FIN-2013-G001) to clarify the applicability of the regulations implementing the Bank Secrecy Act ("BSA") to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies (of which the Bitcoin is by far the most popular). The guidance states in part as follows:

> A user of virtual currency is not an MSB [Money Services Business] under FinCEN's regulations and therefore is not subject to MSB registration, reporting, and recordkeeping regulations. However, an administrator or exchanger is an MSB under FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition applies to the person. An administrator or exchanger is not a provider or seller of prepaid access, or a dealer in foreign exchange, under FinCEN's regulations.

Currency vs. Virtual Currency
FinCEN's regulations define currency (also referred to as "real" currency) as "the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance." In contrast to real currency, "virtual" currency is a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction. This guidance addresses "convertible" virtual currency. This type of virtual currency either has an equivalent value in real currency, or acts as a substitute for real currency.
* * *
Dealers in Foreign Exchange
A person must exchange the currency of two or more countries to be considered a dealer in foreign exchange. Virtual currency does not meet the criteria to be considered "currency" under the BSA, because it is not legal tender. Therefore, a person who accepts real currency in exchange for virtual currency, or vice versa, is not a dealer in foreign exchange under FinCEN's regulations.

E. **The Barter Paradigm.**

It is useful to start with an analysis of how various Bitcoin transactions would potentially be taxed under the “Barter Paradigm,” which treats the Bitcoin as a type of property being exchanged for other property, similar to a purchase or property using gold or silver coins.

1. *Sale or Exchange Treatment Under Code § 1001.*

A transaction involving an exchange of Bitcoin for something else -- $ for Bitcoin, Bitcoin for $, Bitcoin for tangible property or services – should be a sale or exchange transaction under Code § 1001 and the so-called “hair trigger” principles of the Cottage Savings[2] case. In turn, income or gain is recognized currently under Code § 61.[3]

Although few (and possibly zero) employers currently pay employees in Bitcoin, receipt of Bitcoin for services should clearly be within the scope of Code § 83 and thus be considered property received in exchange for services. Significantly, Bitcoin “miners” who receive Bitcoin

[2] *Cottage Savings Association v. Comm*, 499 U.S. 554, 561 (1991).

[3] *See* Joseph B. Darby III, *Barry Bonds' Home Run #756: Could Be a (Tax) Catch*, and case law generally holding that income is realized and generally recognized on any “ascension to wealth” that is not expressly excluded from taxation under the Internal Revenue Code.

for successfully updating the public ledge are very likely in this category. As discussed below, Bitcoin miners may in fact be the winners of a competition, in which case the Bitcoin “prize” is taxable income as well, but under a slightly different tax theory and with different tax consequences. Prizes are reported on Line 21 (Other Income)[4] and are not subject to SECA Tax or FICA Tax.

2. *Is There Any Argument for Non-Recognition under Code § 1031?*

The starting point under Code § 1031(a)(1) is that all property can be “exchanged” tax-free under Code § 1031 for “like-kind” property so long as both the relinquished property and the replacement property are “held” for a qualifying use or purpose. Code § 1031(a)(2) then provides specific categories of intangible property that are not eligible for like-kind exchange treatment, which categories are comprised of the following:

> This subsection [1031(a)] shall not apply to any exchange of—
> (A) stock in trade or other property held primarily for sale[5],
> (B) stocks, bonds, or notes,
> (C) other securities or evidences of indebtedness or interest,
> (D) interests in a partnership,
> (E) certificates of trust or beneficial interests, or
> (F) choses in action.[6]

None of these categories seems to cover the intangible property rights described by a Bitcoin.

[4] *See* IRS Publication 17, Ch. 12, page 94, for 2012 Returns.

[5] The exclusion encompasses two aspects - A) “Stock in trade,” which is property held for sale to customers in the ordinary course of the taxpayers’ trade or business resulting in gain taxed as ordinary income and; B) “Property held primarily for sale,” which is a much more expansive category of excluded property. The word primarily is viewed as being held “principally” or “of first importance.” *Malat v. Riddell*, 383 US 569, 5 L. Ed. 2d 154, 86 S. Ct. 244 (1966). Generally the IRS considers property held primarily for any disposition as falling into the category of property held primarily for sale. Rev Rul 75-292, 1975-2 CB 333; *Wagnesen v. Comm.*, 74 TC 653 (1980).

[6] A chose in action is a right to recover or receive money or other consideration or property, but a chose in action is not considered property in itself. Courts typically look to state law for the definition of a chose in action. See *Miller v. United States*, 63-2 USTC & 9606, SD Ind 1963]. The chose in action exclusion is vague due to the difficulty in defining the term itself and it has rarely been used to disallow non-recognition treatment in an exchange. Some major league player contracts have been considered a chose in action and denied exchange treatment. Ltr Rul 8453034; *Heltzer v. Comm.*, TC Memo 1991-404, 62 TCM 518, 537.

As we will discuss below, the regulations under Code § 988 say that an exchange of a nonfunctional currency for another nonfunctional currency is not eligible for like-kind exchange treatment. Treas. Reg. § 1.988-2(a)(1)(ii). This regulation effectively adds another category of excluded property to 1031(a)(2); but the question remains whether a Bitcoin is properly classified as a "nonfunctional currency," and, if not, then it can very probably be exchanged for "like kind" property, at least in theory.

What is "like-kind" to a Bitcoin? Certainly another Bitcoin -- although Bitcoin, unlike real currencies, do not come in denominations and so a taxpayer would never need to get "change" for a Bitcoin. By contrast, exchanging a €100 Euro bill for ten €10 Euro bills is not considered taxable (it is an exchange into the same currency, not a different currency).[7]

3. Code § 1221 Analysis Applied to a Bitcoin.

[7] The authority that "making change" is not a taxable event is found in § 1.988-2, which is curiously unclear about whether this is because the transaction is a "like kind" exchange or because it is simply exempted by that regulation. The relevant language is found in 1.988-2(a)(1)(ii) and (iii), which read in relevant part as follows; Recognition and computation of exchange gain or loss.

(a)Disposition of nonfunctional currency—

(1)Recognition of exchange gain or loss—

* * *

(ii)Clarification of section 1031. An amount of one nonfunctional currency is not "property of like kind" with respect to an amount of a different nonfunctional currency.

(iii)Coordination with section 988(c)(1)(C)(ii). No exchange gain or loss is recognized with respect to the following transactions—

(A) An exchange of units of nonfunctional currency for different units of the same nonfunctional currency;

(B) The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or other financial institution if such instrument is denominated in such currency;

(C) The withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency;

(D) The receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument; and

(E) The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution.

Code § 1221(a) states that all property is a capital asset except for eight specific categories listed in Code § 1221(a)(1)-(8). All but two involve use of the relevant property in the ordinary course of business.[8]

Two of these eight categories bear at least a brief additional examination: Code § 1221(a)(1) (whether a Bitcoin could be construed as "inventory,") and Code § 1221(a)(3) (whether a Bitcoin is a form of copyrightable property in the hands of the person whose personal efforts created the property).

4. Tax Character of Gain Where Bitcoin Are Exchanged in a Trade of Business Transaction (expenses deductible under Code § 162).

The first question to pose is whether Bitcoin, if they surge in popularity and in the future are regularly used as a true "virtual currency" for buying and selling other property, might be considered "inventory" of a business. Start with the observation that, in unusual historical circumstances, certain goods or commodities have been used as a form of barter currency. In World War II, for example, US soldiers in France used three things as *de facto* currency, in the following order of importance: 1) cigarettes, 2) chocolate, 3) nylons. Assume that at a future point in time (maybe even the near future) a small convenience market uses Bitcoin to buy cigarettes, sells the cigarettes for Bitcoin, uses the Bitcoin to buy more cigarettes, etc. Is the inventory of that convenience market the cigarettes, the Bitcoin – or both? It is an interesting question and perhaps there is no easy or automatic answer. Put it this way: If the Bitcoin is not inventory in that situation, does it necessarily have to be classified as a form of currency? The "in between" answer would appear to be that the Bitcoin is a property being traded almost continuously but nonetheless retaining its character as an investment-type asset, and therefore

[8] Code § 1221(a)(3) and (5).

each exchange presumably generates gain or loss. This would likely result in a long reportable list of short-terms gains and losses in the course of the year.

5. Code § 1221(a)(3) and Copyrightable Property.

Code § 1221(a)(3) is the most significant nonbusiness exclusion under § 1221(a), and applies to certain copyrightable intellectual property, including literary and artistic compositions.[9] Bitcoin are intangible, and Bitcoin miners technically have a hand in "creating" them, but this process is more akin to following a recipe than to composing a symphony. All Bitcoin are exactly alike, and miners are not creating an original work that would qualify for copyright protection.[10] It is true that, under present case law, software in the hands of an individual whose personal efforts created the software is considered property described in Code § 1221(a)(3)(A) and therefore an ordinary asset.[11] However, even if the very first Bitcoin (or possibly the underlying software) is copyrighted intellectual property described in Code § 1221(a)(3)(A), it should only be an ordinary gain asset in the hands of its creator, or on the hands of someone whose tax basis is determined with reference to the original creator's basis.[12] Thus, Bitcoin does not seem to fit easily or comfortably into this exclusion either, since millions of identical Bitcoin are "created" by many diverse parties.

The tentative conclusions are that a Bitcoin might be considered inventory in the hands of a business that turned Bitcoin into a *de facto* currency, but there is no certainty on that issue, and probably few if any businesses (at the moment) that generate a sufficient number of Bitcoin

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[9] 26 U.S.C.A. § 1221 (West).

[10] 17 U.S.C.A. § 102 (West).

[11] *Levy v. C. I. R.*, 64 T.C.M. (CCH) 534 (T.C. 1992).

[12] Code § 1221(a)(3)(C).

transactions. That may, however, change in the future – and possibly in the near future in at least a few cases.

6. Tax Character Where Bitcoin Are Held for Investment (Expenses Deductible Under Code § 212).

Based on the preceding discussion of Code § 1221(a), it seems likely that a Bitcoin purchased for investment purposes should be a capital asset in the hands of the investor, absent an over-ride by Code § 988. Purchasing a Bitcoin with US currency will not result in taxable gain or loss to a US taxpayer.[13] On the other hand, exchanging a Bitcoin for US currency should be a taxable event, generating capital gain or loss, which will be long-term of short-term depending on the holding period.[14]

7. Tax Character Where Bitcoin are Used as a De Facto Currency for Purchasing and Selling Personal Assets (Expenses and Losses Not Deductible Under Code § 262).

A significant question to ponder is whether Bitcoin might be considered some kind of "personal asset" subject to disallowance of deductions or losses under Code § 262. This does not seem likely under the "Barter Paradigm," because a Bitcoin is not the same as a boat, vacation home or sports car – the "personal use" element is hard to identify with respect to the Bitcoin itself. The only reason this question seems worth considering is the fact that Code § 988(e) disallows losses from personal transactions in a non-functional currency.[15]

Even on carefully and open-minded consideration, it is hard to see how a Bitcoin under the Barter Paradigm is not an asset that qualifies as a capital asset under Code § 1221(a) and is not similar to an investment-type asset, *e.g.*, gold or silver coins. But there remains a potential

[13] It is an interesting technical discussion whether this is a taxable exchange where the US currency has full tax basis, or whether it is not a taxable transaction at all because of the unique characteristics of money.

[14] Code § 1222.

[15] See discussion regarding Code § 988(e) below.

practical difference, which is that gold and silver coins, for example, are clearly a popular investment-type asset, and are furthermore classified as “collectibles” and subject to a special 28-percent tax rate under Code § 1(h)(4) and(5).[16] Bitcoin almost certainly are not a “collectible”, but even if they were then both gain or loss would be recognized and reported by the taxpayer (albeit subject to the higher 28-percent tax rate).

F. <u>The Foreign Currency Paradigm.</u>

1. Introduction.

In the alternative treatment where Bitcoin were instead characterized as a form of money, *e.g.*, a “foreign currency,” then the tax rules would be significantly different. A US taxpayer is subject to tax on worldwide income,[17] and that income is ultimately translated into US dollars and the tax is paid in US dollars. Interestingly, foreign currency is characterized for US income tax purposes as personal property, with a tax basis under Code § 1012, and with a recognition event under Code § 1001 each time the foreign currency is used in a sale or exchange transaction. When a foreign currency is exchanged for another foreign currency, gain or loss is recognized, measured by the FMV of the currencies at the time of the exchange.[18]

[16] Code § 408(m) defines collectible as follows:

(A) any work of art,

(B) any rug or antique,

(C) any metal or gem,

(D) any stamp or coin,

(E) any alcoholic beverage, or

(F) any other tangible personal property specified by the Secretary for purposes of this subsection.

[17] Code § 61.

[18] Philadelphia Park Amusement Co. v. US, 126 F. Supp. 184 (Ct. C. 1954).

As noted above, recent guidance has been issued by FinCEN, a division of the Department of Treasury, asserting that Bitcoin should not be treated as a "real currency,"[19] but that was for non-tax purposes, and there is at least a reasonable possibility at the time that the digital money may be taxed like a foreign currency under Code § 988, which would generally produce ordinary income and losses when the currency is used in a business, but – perhaps distressingly for taxpayers – produces capital gains and non-deductible losses for non-business transactions.

2. Code § 988.

Code § 988 is an interesting and complicated (and LONG!) provision of the Internal Revenue Code, but its principles can be distilled into the following elements:

a. foreign currency is generally treated as a type of property received in an exchange, and

b. Code § 988 does not create gain recognition where none otherwise exists, but merely changes the character of the gain to ordinary income, and in some cases also changes or identifies the source.

For example, assume a US Dollar and a Euro are exactly equal in value, and a US taxpayer (USTP) pays $100 to buy 100 E. The Euro then appreciates relative to the dollar and now €1 equals $1.20. The US taxpayer then exchanges the €100 back to US currency and receives $120. This is a taxable event, under both Code §§ 61 and 1001, and USTP has gain recognition of $20. Under Code § 988, this gain is ordinary.[20]

[19] FinCEN, FIN-2013-G001, March 18, 2013, *available* at http://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html (Last visited Apr. 2, 2013). As noted above, the US Treasury has already said that a Bitcoin is a "virtual currency" and not a "real currency" for purposes of the Bank Secrecy Act, but then also called it a "convertible virtual currency" and concludes that Bitcoin transactions come within the scope of that act for at least some reporting purposes.

[20] There is a possibility that a taxpayer can elect out of Code § 988 and into Code § 1256 for a "pure" currency investment transaction, but that is subject to uncertainty.

Code § 988(a)(1)(A) states the general rule that "any foreign currency gain or loss attributable to a Code § 988 transaction shall be computed separately and treated as ordinary income or loss (as the case may be)." Code § 988(c)(1)(C) says a disposition of a non-functional currency is a "Section 988 transaction." To the extent provided in regulations, any amount treated as ordinary income under Code § 988(a)(1) is treated as interest income or expense (as the case may be). Acquisition of a nonfunctional currency does not give rise to exchange gain or loss, but it does establish the tax basis in the non-functional currency for purposes or later determining gain or loss on disposition. Treas. Reg. § 1.988-1(a)(1) and (a)(6), EX. 1 and 2.

NOTE: There are special rules for determining whether the US dollar is the "functional currency" for a US taxpayer (thereby making all other currencies "non-functional"), but an individual US taxpayer will generally not be a Qualified Business Unit and therefore will treat the US currency as his/her functional currency.

3. Tax Character of Gain or Loss under Code § 988 for Transactions in a Trade or Business (expenses deductible under Code § 162).

Code § 988 will treat gain or loss from foreign currency transactions as ordinary income or loss, in the nature of interest income and interest expense. Code § 988 covers both gains and losses from trading into and out of a foreign currency from actual business operations, *e.g.*, buying inventory with Euros and/or selling the inventory for Euros, and also covers gain or loss occasioned by currency fluctuations between the purchase or sale date and the date when the currency is actually converted back into US currency.

Note: There are special rules under Code § 988 that allow a taxpayer to elect out of Code § 988 treatment for certain transactions, and instead such transactions are typically treated as subject to Code § 1256. These rules are beyond the scope of this article.

4. Tax Character of Gain or Loss under Code § 988 for Investment Transactions (expenses deductible under Code § 212).

Code § 988(c)(1)(C) treats "any disposition of any nonfunctional currency" as a § 988 transaction, and so this provision basically means that a US taxpayer cannot treat a direct investment in currency as an investment in a capital asset. As noted above, there is presently uncertainty about whether a US taxpayer can elect out of § 988 with respect to a direct investment in currency, but that appears to be at least a possibility at this time.

5. Tax Character of Gain or Loss under Code § 988 for Personal Transactions.

Special rules apply under Code § 988(e) to a transaction enter into by an individual which is a "personal transaction." In a personal transaction, no gain is recognized by reason of changes in exchange rates after the currency was acquired and before disposition, so long as the gain from currency fluctuations does not exceed $200. Instead, an individual who spends (exchanges) foreign currency in a personal transaction is exempted from recognizing gain on the currency fluctuations unless such gain exceeds $200. Code § 988(e) expressly exempts gain that arises because of fluctuations in the exchange rate while the individual holds the foreign currency. It appears that this $200 limit applies on a transaction by transaction basis, and not on a cumulative annual basis.[21] Losses, meanwhile, are treated as losses from a personal transaction and are generally nondeductible.[22]

A "personal transaction" is any transaction entered into by an individual[23] except to the extent that expenses properly allocated to the transaction meet the requirements for deductibility as a trade or business expense (other than travel expenses in connection with a business trip)[24] or as an expense for the production of income or for the management, conservation, or maintenance

[21] RIA Federal Tax Coordinator, G-7047.
[22] Code § 262. See H.R. Rept No. 105-148, 105th Cong, 1st Sess, p. 526.
[23] Code § 988(e)(3).
[24] Code § 988(e)(3)(A).

of property held for the production of income (but not expenses in connection with the determination, collection or refund of taxes).[25] Thus, transactions entered into in connection with a foreign business trip are personal transactions.[26]

G. <u>Foreign Bank Account Reporting (FBAR).</u>

1. Introduction.

The instructions to FinCen Report 114 (formerly Form TD F 90-22.1) contain the following requirements and definitions:

> <u>Who Must File an FBAR</u>. A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year. . . .
>
> <u>Financial Account</u>. A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund (i.e., a fund that is available to the general public with a regular net asset value determination and regular redemptions).

2. JBD3 Comment:

On the face of the FBAR definition of "financial account," it does not appear that the mere act of holding Bitcoin in an individual electronic format or a "wallet" (sometimes also referred to as "cold storage") should be considered a "financial account" within the scope of the FBAR reporting requirements. It is also thought that certain websites that offer only "online wallet" services, and which do not provide any other financial services, would be considered the same as an individual "wallet" and would not require reporting.

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[25] Code § 988(e)(3)(B).
[26] Conf. Rep.t No. 1-2-220, 105th Cong, 1st Sess, p. 617.

On the other hand, it was generally believed than an account maintained at a Bitcoin storage facility, such as the (now defunct) Mt. Gox, would probably come within the scope of a reportable "account" and thus be subject to FBAR reporting.

Nonetheless, until June 2014, great uncertainty existed about whether Bitcoin should be disclosed on an FBAR return.

3. Informal Announcement – June 2014.

In news reports that first appeared in Bloomberg BNA on June 5, 2014, and then were repeated in *Forbes* Magazine on June 30, 2014, it was reported that FinCEN was not requiring the reporting of Bitcoin on the FBAR "at the present time," but that FinCEN "may consider requiring such accounts to be reported in the future." The source or this information was identified as Rod Lunquist, a senior program analyst for the Small Business/Self-Employed Division at the IRS, who spoke as part of an IRS webinar titled, "Reporting of Foreign Financial Accounts on the Electronic FBAR." Lunquist cautioned that the exception might end in the future as the authority monitors developments in the digital currency space.

"At this time, FinCEN has said Bitcoin is not reportable on the FBAR, at least for this filing season," said Lundquist during the webinar, as first reported by Bloomberg BNA.

This "announcement," which was a "news" event rather than a formal IRS or FinCEN document, led to uncertainty and puzzlement, especially with respect to the reporting status of accounts held in Bitcoin brokerage or exchange accounts. The real concern is that these Bitcoin brokerage and exchange organizations may well be classified as "financial institutions" or "banks", particularly in light of the recent decision, *United States v. Hom*,[27] by the U.S. District Court for the Northern District of California, which held, among other things, that online poker

[27] 113 AFTR 2d 2014-2325.

sites PokerStars.com and PartyPoker.com were properly classified as commercial banking financial institutions under the Bank Secrecy Act.

4. FinCEN Announcement on Virtual Currencies – March 2013.

As discussed above, in the FinCEN document entitled "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," issued March 2013, the US Treasury took the position that any business that transfers virtual currencies, or that exchanges virtual currencies for real currencies, is considered a money transmitter for registration and reporting purposes under the Banking Secrecy Act. Based on that announced position, it seems pretty clear that bitcoin payment services and currency exchanges are "financial institutions" for FBAR purposes.

The largest and most famous of the bitcoin exchange organization, Mt. Gox in Japan, suspended operations in February 2014 and filed for bankruptcy protection. Significant Bitcoin exchanges currently include BTCChina in China, BitStamp in Slovenia, and BTC-e in Bulgaria. A US person storing Bitcoin at these or other similar exchanges is very likely subject to the FBAR reporting requirements.

<u>NOTE</u>: FBAR reporting applies if the value of ALL assets held in foreign financial accounts exceeds $10,000 at any time during the calendar year. More than $10,000 of BTC would trigger a reporting obligation, but so would any amount of BTC held in such an account, coupled with other reportable assets held in other foreign financial accounts, if the aggregate value exceeds $10,000.

H. <u>FATCA -- Form 8938 Reporting Obligations.</u>

1. <u>Who Must File Form 8938</u>.

Unless an exception applies, you must file Form 8938 if you are a specified individual that has an interest in specified foreign financial assets and the value of those assets is more than the applicable reporting threshold. The reporting threshold for unmarried individuals is reportable assets totaling $50K at the end of the applicable year or $75K at any time during the year. For married individuals, the reporting threshold is $100K or more at the end of the applicable year, or $150K or more at any time during the year.

2. Specified Foreign Financial Assets and Related Definitions.

"Specified foreign financial assets" subject to reporting on Form 8938 includes any financial account maintained by a foreign financial institution, and any of the following assets which are not held by a foreign financial institution: any stock or security issued by a person other than a United States person; any financial instrument or contract held for investment that has an issuer or counterparty which is other than a United States person; and any interest in a foreign entity.[28] The term "financial institution" for FATCA purposes means any entity that accept deposits in the ordinary course of a banking or similar business, or, as a substantial portion of its business, holds financial assets for the account of others, or is engaged primarily in the business of investing, reinvesting or trading in securities, partnership interests, or commodities.[29] The term "financial account" means, with respect to any financial institution, any depository account or any custodial account maintain by such financial institution, or any debt or equity interest in such financial institution (other than interests regularly traded on an established securities market).[30]

3. Reporting Rules for Bitcoin and Bitcoin Investment Vehicles.

Bitcoin exchanges generally accept deposits in the ordinary course of business. Bitcoin investment vehicles hold financial assets for the account of others and engage in investing,

[28] Code § 6038D(b).
[29] Code § 1471(d)(5).
[30] Code § 1471(d)(2)

reinvesting and trading in virtual currencies. Therefore, based on the criteria and definitions above, the reporting requirements for Form 8938 seem to mirror the generally reporting dichotomy for FBAR: individual Bitcoin holdings held in a wallet should not constitute a financial account at a foreign financial institution, regardless of "where" the account is deemed to be held; while accounts held at Bitcoin exchanges or investments in Bitcoin investment vehicles are very likely reportable on Form 8938 if the applicable reporting thresholds are met.

NOTE: Again, the reporting thresholds represent the aggregate of all reportable assets during the applicable year, so a reporting event can be triggered if Bitcoin holdings, together with other assets and holdings in specified foreign financial assets,

I. <u>Net Investment Income Tax.</u>

Notice 2014-21 seems to make it clear that many Bitcoin transactions will result in capital gain (or loss) and net capital gain, in turn, should be subject to the Code § 1411 Net Investment Income Tax.

As discussed above, businesses that regularly trade in Bitcoin may well be able to argue that they are "dealers" in Bitcoin and that Bitcoin is "inventory," in which case the net income from such transactions should not be subject to the NIIT.

J. <u>IRS Audits of Bitcoin Usage.</u>

The IRS website, www.irs.gov, provides in its "Audit Techniques Guide" several ways that an IRS agent can uncover a taxpayer's use of digital money.[31] Examiners are instructed to analyze bank statements to look for unusual activity, and evidence that the taxpayer's spending is unreasonable compared to his or her reported income.[32]

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[31] *See* "*Cash Intensive Businesses Audit Techniques Guide - Chapter 7 - Digital Cash and Electronic Money*, which is found at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Cash-Intensive-Businesses-Audit-Techniques-Guide-Chapter-7.

[32] *Id*.