

Bitcoins: Putting Your Money Where Your Mouse Is

By Joseph B. Darby III¹ and William Schiffman²

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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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 it 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 must 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.

Solving the Puzzle of Bitcoin Taxation

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 Savings³ 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 ledger 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.]

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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 sale⁵,
- (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

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]

non-functional 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 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

⁷ Code § 1221(a)(3) and .

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 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-term 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

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)

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.

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 or 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

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.

furthermore classified as “collectibles” and subject to a special 28-percent tax rate under Code Section 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:

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.

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 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 entered 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).

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

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].

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 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 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

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)

²⁶ *Id.* at 401

²⁷ *Id.* at 403; See also *United States v. Maginnis*, 356 F.3d 1179, 1182 (9th Cir. 2004).

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

What if the IRS Says a Bitcoin is "Money"

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 foreign currency,³³ but that was for non-tax purposes, and there is

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)

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)

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)]

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!

FBAR Reporting and FATCA Compliance

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 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

³⁴ 26 U.S.C.A. § 988 (West)

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

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 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 companies⁴³ 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

⁴² Federal Bureau of Investigation, *Bitcoin Virtual Currency: Intelligence Unique Features Present Distinct Challenges for Deterring Illicit Activity*, (April 2012) [hereinafter "FBI on Bitcoin"]

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.*

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 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.