

TAXTALK

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IRS ISSUES GUIDANCE ON VIRTUAL CURRENCY

In Notice 2014-21, the IRS issued guidance on virtual currency, such as Bitcoin. The notice, which is in the format of answers to frequently asked questions, describes how existing tax principles apply to transactions involving virtual currency.

By way of background, the IRS explained that virtual currency behaves like “real” currency, in that it may be used and accepted as a medium of exchange, although it is not recognized as legal tender in any jurisdiction. The notice, however, applies only to “convertible” virtual currency, which the IRS describes as virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency. In other words, convertible virtual currency is virtual currency that may be purchased for, or exchanged into, U.S. dollars or euros, for example.

As a threshold matter, the notice provides that convertible virtual currency is simply property for U.S. federal income tax purposes, even if it may be exchanged for

real currency. The IRS’s conclusion, of little surprise, helpfully confirms that transactions involving virtual currency will not be subject to the rules governing foreign currency. Instead, taxpayers will be subject to the full gamut of tax principles generally applicable to property transactions. Although treatment of convertible virtual currency as property makes sense and, at first blush, seems relatively straightforward, even some of the most basic transactions involving virtual currency are rife with latent tax implications and may result in a record-keeping nightmare for holders of virtual currency.

As an example, virtual currency holders will be required to track their basis in the currency since any exchange is likely to result in the holder recognizing gain or loss. The character of the gain or loss, in turn, will depend on whether the virtual currency is a capital asset in the hands of the taxpayer. In this vein, complex valuation issues abound. In anticipation of these valuation questions, the notice provides that if a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the taxpayer may use the fair market value of the virtual currency as determined by converting the virtual currency into U.S. dollars at the exchange rate. Of course, this begs the question of which exchanges will be considered adequate marketplaces with respect to the relevant virtual currency – a question well outside the scope of our expertise.

Furthermore, if a virtual currency is received as payment for goods or services, the recipient will be required to include the fair market value of the virtual currency in gross income. Indeed, to the extent virtual currency is received as wages, it may be subject to employment taxes in appropriate circumstances. Moreover, transactions involving virtual currency may implicate certain information reporting and backup withholding obligations. Finally, “mining” – the process of creating or issuing the currency by solving what essentially amounts to complicated math problems – may give rise to gross income, in cases where the taxpayer receives virtual currency as compensation for these activities.

In sum, although virtual currency may be commonplace in cyberspace, it continues to pose new and unexpected tax challenges. For now, however, virtual currency holders will have to make do with the guidelines set forth in the notice. As the IRS continues to navigate these uncharted waters, we promise to keep you in the loop.