

April 3, 2014

IRS Issues Pronouncement on Virtual Currencies

On March 25, the Internal Revenue Service (IRS) issued Notice 2014-21 (notice) containing guidance and frequently asked questions relating to virtual currencies such as bitcoins.¹ Among other clarifications, the notice states that the IRS will treat bitcoins as property, rather than a form of currency, for federal income tax purposes. Prior to the notice, no federal agency had released formal guidance relating to the asset classification of bitcoins or other virtual currencies. US Senator Tom Carper, who chaired virtual currency hearings last November and has previously called for the US to “lead the way” on bitcoin regulation, praised the notice as providing a framework for tax compliance among industry participants.²

The notice applies to bitcoin and other virtual currencies (which, in general, we collectively refer to as digital assets). For a detailed analysis of bitcoins and their uses and applications, please see our advisory dated November 26, 2013.³

Summary of Bitcoin

Bitcoin is a type of digital asset that is based upon a peer-to-peer, decentralized, computer-generated, math-based and cryptographic protocol. Bitcoins may, among other things, be used to buy and sell goods or services, or as a unit of account.⁴ Bitcoins may be converted to fiat currencies, such as US dollars or other national currencies based on then-current exchange rates. Approximately 12.5 million bitcoins currently exist and, based on the bitcoin formula, the maximum number of bitcoins that will ever exist is 21 million.

There are approximately 200 other digital assets being used today, of which 11 have a market capitalization in excess of \$10 million as of March 26, 2014, and many of which are based on protocols similar to or derived from the protocol and computer network that underlie bitcoin transactions (Bitcoin Network). These digital assets have achieved only a fraction of the market capitalization of bitcoin in part due to the Bitcoin Network’s status as a first mover in the digital asset space and its relatively rapid, widespread adoption.

Classification of Bitcoin as Property

Over the past year, government examination of the Bitcoin Network has increased both domestically and in foreign jurisdictions. However, until the notice, no federal agency had issued definitive guidance on how digital assets should be treated for federal income tax purposes.

¹ Internal Revenue Service, Notice 2014-21, March 25, 2014.

² Press Release, “Chairman Carper Reacts to Internal Revenue Service’s New Guidance on Transactions Involving Digital Currencies,” March 25, 2014.

³ Katten Muchin Rosenman LLP, “Bitcoin: Current US Regulatory Developments,” November 26, 2013.

⁴ Prior to the notice, there has been little precedent for the classification of bitcoins as a currency, commodity, commodity money or security. In his written testimony to the US Senate, Jerry Brito of the Mercatus Center at George Mason University stated that a bitcoin “does not comfortably fit any existing classification or legal definition. It is not a foreign currency, nor a traditional commodity, nor is it simply a payments network.” To view Jerry Brito testifying before the Senate Committee on Homeland Security and Governmental Affairs on bitcoin, click [here](#).

To request additional information, or to further discuss bitcoin and other digital assets, please contact any of the following attorneys that represent digital asset businesses.

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While federal agencies are not bound to treat or classify assets uniformly, the notice affirmatively states that the IRS deems digital assets akin to property, and not a form of currency, for federal income tax purposes. The distinction has significant implications in respect of bitcoin's uses as an investment tool and a payment system.

The notice acknowledges that "virtual currency" can be used like "real" currency (i.e., coin and paper money) despite the fact that no jurisdiction has recognized bitcoin or other digital assets as legal tender. The notice also distinguishes "convertible virtual currencies," such as bitcoins, from other digital assets, because bitcoin users can exchange bitcoins for "real" currency. The notice issues guidance only as to the federal income tax consequences of convertible virtual currencies and assumes that: (1) the real currency used is the US dollar; (2) the cash receipts and disbursements method of accounting is used; and (3) the taxpayer is not under common control with any other party to a transaction.

Tax Guidance for Bitcoins and Other Digital Assets

Listed below are some of the implications of the notice for various types of participants in the bitcoin ecosystem. Such implications are also applicable to users of other digital assets such as litecoin, dogecoin and ripple.

Implications for Bitcoin Investors

The notice classifies bitcoin as property for tax purposes and states that the capital asset rules apply to investments in bitcoin like other forms of property. Accordingly, an investor in bitcoin may qualify for more favorable long-term capital gains rates on investment income and may offset capital losses against such gains. The notice also confirms the position taken in the tax disclosure contained in the registration statement on Form S-1 filed by the Winklevoss Bitcoin Trust with the Securities and Exchange Commission for the first bitcoin exchange-traded fund.⁵

If the IRS had classified bitcoins as a form of currency, any gains recognized by an investor from the disposition of bitcoins (regardless of how long he or she held the bitcoins) would be treated as ordinary income and taxed at higher rates. By classifying bitcoin as property, non-corporate investors who hold bitcoins for longer than one year can recognize long-term capital gains on their appreciation and be taxed at a lower rate. However, bitcoin investors cannot use their bitcoin losses to offset gains from currency trading.

Implications for Bitcoin Users

The establishment of clear guidance is beneficial because bitcoin users can understand their tax reporting obligations associated with using bitcoin. At the same time, the notice imposes record-keeping obligations on bitcoin users.

As with any other form of property, the sale or transfer of bitcoins in barter results in a taxable event for a bitcoin user. In the context of a purchase of goods or services for bitcoins, the purchaser has a taxable gain if the fair market value of the goods/services received exceeds the spent bitcoins' adjusted basis (i.e., the net cost in US dollars of the purchaser's acquisition of the bitcoins), and a loss if the fair market value of the goods/services received is less than the spent bitcoins' adjusted basis.

Implications for Bitcoin Businesses

Bitcoin-related businesses will generally benefit from the clarity provided by the notice; however, as with individual users, the guidelines impose a record-keeping burden.

Businesses (or employees and independent contractors) receiving payment in bitcoins must report as income the bitcoins' fair market value in US dollars on the date of receipt (which fair market value represents the cost basis for such bitcoins). The fair market value of bitcoins is established by calculating the US dollar value of the bitcoins at the then-current exchange rate (one can determine the current exchange rate by using a bitcoin price index such as Winkdex.com).⁶ To the extent that the bitcoins received as payment are later sold or exchanged, a taxpayer may realize a gain or loss on such bitcoins.

Upon sale or exchange of bitcoins, a taxpayer realizes a capital gain or loss if the bitcoins are held as a capital asset (e.g., investment property) in the hands of the taxpayer. If the bitcoins are not a capital asset (e.g., they constitute inventory and other property held mainly for sale to customers in a trade or business), the taxpayer will realize ordinary income or loss upon the sale or exchange.

⁵ Katten Muchin Rosenman LLP serves as counsel to Winklevoss Bitcoin Trust.

⁶ Katten Muchin Rosenman LLP serves as counsel to the producer of Winkdex.

Businesses that pay employees or contractors in bitcoins must also treat such payments as they would any other salary paid in property rather than currency. The fair market value of bitcoins paid as wages is subject to withholding for federal income tax purposes and must be reported on Form W-2. Such wages are also subject to the Federal Insurance Contributions Act tax and Federal Unemployment Tax Act tax and must be reported to the IRS and the payee if in excess of \$600 in value during a taxable year. Businesses may realize a gain or loss from the disposition of the bitcoins used to pay employees or contractors.

Third parties who settle bitcoin payments on behalf of a substantial number of merchants that accept bitcoins from customers are considered third party settlement organizations (TPSOs). TPSOs must report payments to a merchant on Form 1099-K if (1) the TPSO settles more than 200 transactions for the merchant in a calendar year and (2) the gross amount of payments to the merchant exceeds \$20,000 in value in a calendar year. Bitcoin payments are aggregated with real currency payments (and payments in other digital assets) to determine if the TPSO must report on Form 1099-K. The value of the bitcoins is their fair market value determined as of the date of the payment.

Implications for Bitcoin Miners

Bitcoin miners that use “computer resources to validate bitcoin transactions and maintain the public bitcoin transaction ledger” must include in their gross income the fair market value of the bitcoins they earn from mining activity as of the date of receipt. Mining activities undertaken as a trade or business, and not as an employee, can constitute self-employment and are subject to the additional self-employment tax. Mining as an independent contractor also constitutes self-employment and is subject to the self-employment tax.

Reporting Obligations

A taxpayer’s reporting obligations for bitcoin are similar to other tax reporting obligations in that the taxpayer may be subject to accuracy-related penalties pursuant to Section 6662 of the Internal Revenue Code (Code) and information reporting penalties pursuant to Sections 6721 and 6722 of the Code for underpayments or failing to timely or accurately report bitcoin transactions.

In the notice, the IRS also made clear that the reporting and tax obligations arising from the use of digital assets also applies to transactions that occurred prior to March 25, 2014 (the date of the notice). As such, taxpayers should discuss their acquisition, ownership, sale and use of bitcoin or other digital assets with their tax preparers. Taxpayers may be able to obtain penalty relief if they are able to establish reasonable cause for the underpayment or failure to properly file.

Further Comment

The Treasury Department and the IRS requested comments regarding the tax consequences of digital assets that were not addressed in the notice. Comments can be mailed or hand delivered to the addresses listed in the notice, or submitted via e-mail to Notice.Comments@irs.counsel.treas.gov, with “Notice 2014-21” included in the subject line.

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