Bitcoin and Beyond: The Reality of Taxing and Regulating Virtual Currency

By Jason B. Freeman, JD, CPA | Column Editor

Bitcoin and other virtual currencies have become a growing part of our modern economy. Although their future remains a source of uncertainty – they could, after all, become anything from the future of finance, to the new "offshore banking system" or just a defunct and failed experiment – this virtual phenomenon is a modern-day reality. Perhaps not surprisingly, in the past few years they have been the target of global regulators and tax authorities. Because they fall outside the historic paradigm of government-backed currency, virtual currencies raise a number of interesting questions about how they should be treated for tax and other regulatory purposes.

Virtual currency is generally defined as a digital representation of value that functions as a medium of exchange (in some environments, much like a "real" currency) that is not issued or backed by a government and does not have legal tender status in any jurisdiction. Bitcoin is perhaps the most well-known virtual currency and has largely become synonymous with the industry, but there are a number of competitors, such as Ripple, Ether and Litecoin, to name a few. Bitcoin, itself, has proven to be highly volatile; its market price, driven by the forces of supply and demand, has fluctuated by more than $1,000 per unit over roughly the past two years.

Nonetheless, major retailers like Overstock, Microsoft and Amazon have jumped on board, accepting Bitcoin in some form or fashion – either directly or through an industry of gift card providers that serve as a go-between for exchanging virtual currency – lending weight and legitimacy to the virtual-currency movement. In fact, Blockchain.info, a Bitcoin data tracker, calculates that there are now nearly 16,000,000 Bitcoin in circulation and that figure will continue to grow as more Bitcoin are "mined" in the future.

Virtual currencies pose a number of challenges. Because virtual currencies offer relative anonymity, many fear that they could facilitate tax evasion, money laundering and other underlying crimes, operating as a sort of shadow "banking system." And because they operate in a decentralized manner, their unregulated growth also threatens many of the traditional tools of economic policy and regulation. These perceived threats have prompted regulators to give particular focus to their treatment.

To date, the IRS and other regulators have issued some basic guidance, but they have left many important questions unresolved. The primary philosophical dispute has been whether to treat Bitcoin as property or currency – a question with implications in a number of contexts. Virtual currencies, after all, bear characteristics of both property and currency. The IRS, for its part, has opted to treat Bitcoin as property, much like stock or real estate. This characterization appears in line with the position taken by the Commodity Futures Trading Commission (CFTC), which characterizes Bitcoin and other virtual currencies as "commodities," but seems in tension with the U.S. Treasury Department's Financial Crimes Enforcement Network's (FinCEN) position that virtual currencies are more akin to (or at least a substitute for) real currencies for purposes of regulating "money transmitters." Perhaps the relevant principle at play here is that regulators are likely to take the view that brings virtual currency within their purview and, of course, it is not necessary that federal, state or foreign jurisdictions take consistent stances.

The Basic Tax Approach

The use of convertible virtual currency like Bitcoin can have "real" federal tax implications. As previously mentioned, the IRS generally treats it as property, rather than currency, for federal tax purposes. As a result, for example, virtual currency does not give rise to foreign currency gain or loss for U.S. tax purposes. A taxpayer who receives virtual currency as payment for goods or services must include its fair market value in gross income and takes a corresponding "basis" in the virtual currency equal to its fair market value.

If a taxpayer exchanges virtual currency for property, the taxpayer may realize gain or loss (much like any other property transaction) based on the difference between the taxpayer's basis in the property and its fair market value. The character of the gain or loss (i.e., capital or ordinary) is determined under normal federal tax principles: It is capital if the virtual currency is a capital asset in the hands of the taxpayer and ordinary otherwise. If capital in nature, the gain or loss should be reported on Schedule D, and its related Form 8949, of an individual's Form 1040 return. If ordinary, it should be reported on either line 21 (*Other Income*) or Schedule C of an individual's return, as appropriate.

When virtual currency is used to pay employee wages, the payment must be reported on a Form W-2 and is subject to federal income tax withholding, FICA and FUTA. Similarly, an independent contractor who receives virtual currency for the performance of services has self-employment income that is subject to self-employment tax. In other words, payments made using virtual currency are generally subject to the same information reporting requirements as cash payments. And because payments of virtual currency are also subject to the backup withholding rules, a taxpayer making a payment in virtual currency should be sure to first obtain the payee's taxpayer identification number where necessary to comply with such rules.

One other important aspect of virtual currency taxation is currency "mining." Under existing guidance, currency "miners" recognize gross income equal to the fair market value of the "mined" virtual currency when it is received. The IRS has taken the position that if the taxpayer's "mining" activities rise to the level of a trade or business, the income is also subject to self-employment tax.

Many Unanswered Questions Remain

While regulatory guidance has answered a number of basic questions about the tax treatment of virtual currency, many important questions remain unanswered. AICPA recently underscored this fact, calling on the IRS to issue expanded guidance. Others have voiced similar concerns.

There are numerous questions about how the general property transaction rules apply in the context of virtual currency. For instance, when one virtual currency is exchanged for another, when (if at all) does this give rise to a like-kind exchange under Section 1031? The answer is unclear under existing interpretations and rulings. Likewise, does the installment method under Section 453 apply differently to virtual currency? Again, it is unclear.

Last year, the CFTC ruled that Bitcoin and other virtual currencies are "commodities." This raises the question whether Bitcoin transactions – or derivative transactions – may fall under the "Section 1256 Contract" rules. If so, some such dealings would be subject to Section 1256 and its mark-to-market regime that treats 60 percent of the net gains or losses on Section 1256 Contracts as long term and 40 percent of such gains or losses as short term.

The use of virtual currencies also raises a number of questions regarding international tax and asset reporting requirements. For instance, can holding virtual currencies give rise to an obligation to file a FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR) or Form 8938, *Statement of Specified Foreign Financial Assets*? FinCEN has already deemed administrators and exchangers of virtual currency to be engaged in a "money service business," a type of "financial institution" subject to regulation under the Bank Secrecy Act. This treatment implies that virtual currencies may ultimately be reportable if they can be characterized as a "foreign" account (or similar asset) unless they are otherwise excepted, although the answer in any given case could ultimately depend upon the type of technology underlying the specific virtual currency.

The Future

The emergence of virtual currencies has given rise to questions about their future role in the economy. Are they the future of finance and tomorrow's universal economic medium, or are they destined to fall out of favor and prove a failed experiment? The answer, of course, remains to be seen.

For the time being, however, they have become an increasingly important part of our economy and have been at the center of ongoing regulatory attention. For the armchair regulator, they raise a number of intellectually stimulating and perplexing questions, challenging conventional regulatory regimes and assumptions. And as the rule makers, in seeking to turn the virtual into reality, grapple with those questions, we are likely to see a growing body of rules develop that will serve as the foundation for governing the technologies of tomorrow. ■

Jason B. Freeman, JD, CPA is the managing member of Freeman Law PLLC, based in the DFW Metroplex, and an adjunct professor of law at Southern Methodist University's Dedman School of Law. He can be reached at Jason@freemanlaw-pllc.com.