



## Legal Alert: Virtual Reality: IRS Provides Guidance on the Treatment of Bitcoin and Other Virtual Currency Transactions

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On March 25, 2014, the Internal Revenue Service (IRS) issued Notice 2014-21 (the Notice), which provides guidance regarding the tax treatment of Bitcoins and other virtual currency through a series of “frequently asked questions” (FAQs). The Notice provides that virtual currency is property, rather than foreign currency, for federal income tax purposes, and the FAQ responses address the practical implications of that characterization, including important details regarding the reporting and withholding requirements related to virtual currency transactions. The Notice is not intended to address all tax considerations with respect to virtual currency, which was identified by the Taxpayer Advocate as one of the top 25 issues facing the IRS, but it is a significant starting point. The Notice invites comments on additional tax considerations that may be relevant to virtual currency transactions.

This Legal Alert summarizes the guidance provided in the Notice and addresses the practical implications of the Notice for taxpayers that are engaged in transactions in virtual currency. As discussed below, note that some issues still remain open. Click [here](#) for the full text of the Notice.

### Summary of Guidance

The Notice is directed specifically at virtual currency that can be digitally converted into real currency and exchanged for goods or services. Bitcoins, which are the most widely recognized virtual currency, appear to be the focus of the Notice, but virtual currencies with similar properties also would be impacted. The Notice does not address currencies that cannot be converted into real currency, such as currencies or points systems that may be used in online games, the taxation of which also has been the subject of some discussion.

The Notice treats virtual currency as property, not as currency, for U.S. federal income tax purposes. This treatment is similar to the approach recently taken by certain jurisdictions, including Canada, which applies barter transaction rules when virtual currencies are used to purchase goods or services. However, the Notice departs from the approach taken by other jurisdictions, including the United Kingdom, which is treating virtual currencies more like a government-backed currency and have stopped charging value-added tax on the value of the virtual currencies when they are exchanged for real national currencies. The vast majority of foreign jurisdictions have not released official positions on the treatment of virtual currencies, while a small number of foreign jurisdictions, including China, have restricted the use of such virtual currencies.

The treatment of virtual currency as property for U.S. federal income tax purposes means that, except in the case of taxpayers that sell and exchange

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virtual currency in the course of a trade or business, income and loss from transactions in virtual currency are treated as giving rise to capital gain or loss.

For taxpayer's making longer-term investments in virtual currency (i.e., more than one year), this means that income may be taxed at lower capital gains rates. However, the use of capital losses may be limited because they generally can be used only to offset capital gains. If virtual currency instead were treated as currency for tax purposes, gains and losses with respect to such currency generally would give rise to ordinary income or loss. In that case, taxpayers holding virtual currency for more than one year gains would be subject to higher tax rates rather than capital gains rates, but there would be no limitations on the use of losses.

Consistent with the treatment of virtual currency as property, the Notice provides that:

- A recipient of virtual currency as payment for goods and services must include the fair market value (FMV) of the virtual currency in computing its gross income, and it would have an FMV basis in the virtual currency received;
- The payer in such a transaction has gain or loss upon the disposition of its virtual currency for cash or in exchange for goods and services, determined as the difference between its basis in the virtual currency and the FMV of the virtual currency at the time of the transaction;
- Virtual currency "miners" have income upon the receipt of the virtual currency, and may be subject to self-employment tax or FICA if they are "mining" virtual currency in the course of a trade or business; and
- The general Information reporting and withholding rules apply to transactions in virtual currency, just as they apply to other transactions in property, meaning generally that transactions in virtual currency exceeding \$600 are required to be reported to the payer and the IRS, unless an exception applies.

The FMV of virtual currency transactions is determined based on the price of the virtual currency on virtual currency exchanges on the transaction date.

#### Practical Implications

Many different types of players have entered the virtual currency market as the popularity of virtual currency, and particularly Bitcoins, has continued to grow. Some of the practical implications of the FAQs for taxpayers that are engaged in

virtual currency transactions include:

- Individual taxpayers that have significant losses from virtual currency trading may find that they are limited in their ability to use those capital losses. As noted above, taxpayers that have gains on virtual currency held for more than one year may be able to take advantage of lower capital gains rates; although, given the relatively recent rise in popularity of virtual currency, it is not clear that this benefit will be available to many taxpayers.
- Each time a taxpayer purchases goods with virtual currency, the taxpayer is required to calculate, and ultimately report to the IRS on its return, the amount of the gain or loss on the virtual currency used in the transaction. For regular users of virtual currency, this results in significant administrative burdens, which may be compounded by the fact that virtual currencies are traded on multiple exchanges and have been subject to significant valuation swings, even within a single day.
- Virtual currency mining may constitute a trade or business, which may permit taxpayers engaged in virtual currency mining to take deductions for ordinary and necessary expenses related to their mining activities. However, it also may subject the miners to self-employment taxes or FICA on the income from their mining activities.

The IRS did not provide relief for taxpayers that have already filed current or prior year returns in a manner that is inconsistent with the new guidance. Those taxpayers will need to consider filing amended returns consistent with this guidance. The IRS stated that it would take into account reasonable cause arguments in determining whether a taxpayer in such a position is subject to penalties. The availability of the reasonable cause exception may be affected by whether a taxpayer takes steps to correct prior returns to reflect the guidance in the Notice.

Taxpayers that facilitate virtual currency transactions also are put on notice that they must ensure that they obtain sufficient information from their customers to satisfy IRS reporting and withholding obligations, or they could face stiff penalties. The application of reporting requirements to virtual currency transactions may discourage users of virtual currency that may have been attracted by the anonymity otherwise provided by virtual currency transactions.

#### Open Issues

The Notice recognizes that there may be questions regarding the tax treatment of virtual currencies not answered by the FAQs. Some of those issues may be

currently apparent, and others will arise as the virtual currency market grows and evolves. Immediately apparent issues include the following:

- U.S. virtual currency businesses, such as exchanges or hosted wallet providers, will have information reporting obligations to the IRS. It is currently unclear whether, and to what extent, foreign virtual currency businesses will have similar reporting obligations.
- The Notice does not address whether virtual currency is considered a financial asset. A taxpayer may have FBAR and Form 8938 reporting obligations if virtual currency is held outside of the U.S.
- Businesses that hold customer accounts in virtual currencies may be considered financial institutions. As such, foreign virtual currency businesses, such as hosted wallet providers and exchanges, may be subject to the Foreign Account Tax Compliance Act (FATCA).

The Notice suggests that further guidance may be provided by the IRS to address these and other open issues.

*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Sutherland attorney with whom you regularly work.*