Federal Tax Issues and Considerations Regarding Virtual Currencies –
A "Work-in-Progress" List and Analysis

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VC = virtual currency

a. Which exchange rate should be used when you need to determine the value of the VC? Must the taxpayer get the rate as of the moment of the transaction or the end of the "normal" business day? Or should an average be computed for the day? For bitcoin, the various exchanges or price listings do not all have the same dollar equivalent. Per Notice 2014-21, any reasonable manner, consistently applied should be used. Some examples would be useful.

b. When bitcoin is used, it is confirmed (through algorithms and the Blockchain). Thus, a specific "coin" (address) was used or received. Thus, it would seem that specific identification must be used to determine the basis of bitcoin used (rather than FIFO, if FIFO is even allowed). But how easy is it for the user to know which address was used? It likely is not possible unless the taxpayer has a new address for each acquisition and is keeping good records of when they acquired each address.[1]

   Under specific identification, the taxpayer must have adequately identified which asset was transferred. For securities, the taxpayer must also have written confirmation of that instruction. See Reg. §1.1012-1(c)(3) and *Hall*, 92 TC 1027 (1989).

   Where specific identification was not performed for sale of securities, the default of FIFO to identify basis is provided at Reg. §1.1012-1(c), but only for securities. FIFO is also allowed for inventory. But is it allowed for any fungible asset where specific identification was not performed or possible?[2]

   For ease of tracking for some taxpayers, should they be allowed to use FIFO? How will the IRS verify gain or loss on use of bitcoin upon examination? What documentation is needed to justify basis? When must it exist? Will tracking via the blockchain be feasible?

c. Personal use – if an individual holds and uses bitcoin for personal purchases, any gains are taxable, but what about losses? Is this bitcoin deemed to be a personal use asset with any losses non-deductible, or is bitcoin presumed or deemed to be an investment asset? What is the relevance, if any, of the holding period (including even a few days, particularly if the value in dollars is fluctuating rapidly)?

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[1] A taxpayer records would also need to track when addresses change. For example, Carol buys clothes for .2btc. She has an address with .3btc that is used for the transaction. When .1btc is returned to her as "change" it will have a new address. However, arguably, looking at the substance of the transaction, it should have the same basis and acquisition date as the original .3btc address she had before she bought the clothes.

[2] Arguably, FIFO should be provided where specific identification was not used in order to prevent any attempt by a taxpayer to improperly specifically identify at the time they file their return.

Note: Some federal tax issues are addressed in Notice 2014-21.

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d. Would "mining" ever not be taxable upon discovery? Bitcoin has a finite number of "coins." Thus, it seems that a "miner" is finding something of value, rather than creating something from scratch, as would be the case with an artist or carpenter (who would not have income until the item created was sold). Additional guidance from the IRS on the rationale for treating "mining" as income would be useful so as to apply to other types of VCs and to help all bitcoin miners know the rationale.

e. There can be significant costs involved in mining - equipment, electricity, labor. Are the expenses of mining to generate bitcoin required to be capitalized under§263(a) or §263A?

   Notice 2014-21 implies that mining is not production or acquisition because the Notice states that mining produces income upon receipt of the VC. Perhaps the view is that the miner is performing services to "unlock" the VC and is rewarded by the system with VC. Under that perspective, the costs of providing the services should be current expenditures deductible under §162 or §212.

   Or, does the answer depend on what the miner does with the VC obtained?

   If the miner regularly sells the VC, is it a reseller possibly subject to §263A (unless within the $25 million gross receipts small business exception)?

f. Inventory rules: Is a business that exchanges bitcoin for sovereign currency a reseller? Isn't this the same as selling other property (exchanging property for cash from customers)? If yes, the §263A rules apply if the reseller has average annual gross receipts in the prior three-year period in excess of $25 million (after the Tax Cuts and Jobs Act). Is the bitcoin treated as inventory? Yes, if it is something held for sale. The inventory accounting rules of §471 should apply (FIFO, lower-of-cost-or-market, etc.), unless the taxpayer is a small business. Also, the bitcoin would not be a capital asset (§1221(a)(1)).

g. A merchant using an exchange to convert bitcoin (or other VC) to dollars needs guidance on whether it has the gain or loss to report on any difference in value between bitcoin when received and when converted and paid by the exchanger (assuming the merchant is using an exchanger). Or, does any gain or loss belong to the exchanger only? The answer should depend on the particular facts and circumstances of the arrangement between the merchant and exchanger. Or, is there a possible position the IRS would take that the merchant must account for all economics of the transaction, even if borne by a third party that enables the transaction to occur (under, for example, a benefits and burdens argument)? Arguably, if the exchanger assumes the conversion risk (and reward), the substance of the transaction is that the merchant should only have to account for the fee they pay to the exchanger, and the normal tax and accounting treatment of the sale of goods or services to the customer who paid with bitcoin.

h. Broker reporting – Does §6045, *Returns of brokers*, apply to a business that exchanges VC for dollars? Would the broker have to issue a Form 1099-B or have to track the customer's basis?

i. Section 475(e) treatment – whether bitcoin and other VCs are a "commodity" is relevant for §475 purposes allowing dealers and traders to possibly mark to market under §475, *Mark to*

*market accounting method for dealers in securitie*s. In 2015, the Commodities Futures Trading Commission ruled that bitcoin was a commodity (In the Matter of Coinflip, Inc, CFTC Docket No. 15-29).

j. Foreign reporting: United States persons must file a report of Foreign Bank and Financial Accounts (FBAR) if they have a financial interest in or signature authority over one or more financial accounts outside of the U.S. and the aggregate value of such accounts exceeds $10,000 anytime during the calendar year.

Per 31 CFR 1010.350, "Each United States person having a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country shall report such relationship to the Commissioner of Internal Revenue for each year in which such relationship exists and shall provide such information as shall be specified in a reporting form prescribed under 31 U.S.C. 5314 to be filed by such persons." Bitcoin is not a bank account or securities. It also does not appear to be an "other financial account in a foreign country." These terms are defined as follows at CFR 1010.350(c):

> "(1) *Bank account.* The term "bank account" means a savings deposit, demand deposit, checking, or any other account maintained with a person engaged in the business of banking.
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> (2) *Securities account.* The term "securities account" means an account with a person engaged in the business of buying, selling, holding or trading stock or other securities.
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> (3) *Other financial account.* The term "other financial account" means—
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> (i) An account with a person that is in the business of accepting deposits as a financial agency;
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> (ii) An account that is an insurance or annuity policy with a cash value;
>
> (iii) An account with a person that acts as a broker or dealer for futures or options transactions in any commodity on or subject to the rules of a commodity exchange or association; or
>
> (iv) An account with—
>
> (A) *Mutual fund or similar pooled fund.* A mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions; or
>
> (B) *Other investment fund.* [Reserved] "

Is bitcoin (or other VC) considered a foreign financial asset for possible reporting the FBAR and on Form 8938, *Statement of Specified Foreign Financial Assets*? Based on the above definition and the fact that virtual property has no location, it seems that the answer is no. However …

Coinbase (coinbase.com), for example, advertises that it is “an international digital wallet.” Also, some VC arrangements may involve an entity holding your VC for you and that entity may be located in another country.

Note this 2014 case involving FBAR and gambling accounts – *Hom*, No. C 13-03721 WHA (ND CA 6/4/14) – H was assessed $10,000 penalty per account for 2006 for 3 accounts and for 1 account in 2007 that were not reported on his FBAR. The funds were in accounts for online gambling (FirePay, PokerStars, and PartyPoker). H argued that these accounts were not "bank or other financial accounts" for FBAR purposes.

The District Court noted that while the 9th Circuit had not ruled on this issue, the 4th Circuit had. “The government claims that FirePay, PokerStars, and PartyPoker are all financial institutions because they function as "commercial bank[s]." Section 5312(a)(2)(B). The Fourth Circuit in *Clines* found that "[b]y holding funds for third parties and disbursing them at their direction, [the organization at issue] *functioned as a bank* [under Section 5314]." *Clines,* 958 F.2d at 582 (emphasis added). So too here. …As FirePay, PokerStars, and PartyPoker functioned as banks, defendant's online accounts with them are reportable.”

H also argued that the funds might not be outside of the U.S. as the three institutions had accounts in the US too. The court noted though that the three institutions are based outside of the U.S. Hom’s “accounts are digital constructs that these financial institutions, all located outside of the United States, created and maintained on his behalf.”

Hom also noted that the instructions to the FBAR for 2010 state: “[t]he geographic location of the account, not the nationality of the financial institution in which the account is found determines whether it is an account in a foreign country." The court noted thought that instructions are not binding and even if they did have relevance, “there is no suggestion here that FirePay, PokerStars, and PartyPoker opened and maintained the defendant's *accounts* in the United States.”

Hom also argued that “the amount of penalty assessed was too high because it *might* contravene the ‘Internal Revenue Manual.’” The court held that the IRM does not have the force of law and confers no rights on Hom.

In 2016, *Hom* was partly overturned - *Hom*, No. 14-16214 (9th Cir., 7/26/16), not for publication. The court analyzed the nature of each of the foreign accounts. For the FirePay account, the court found that it was required to be reported on an FBAR. FirePay met the definition of a money transmitter. It “acted as an intermediary between Hom’s Wells Fargo account and the online poker sites. Hom could carry a balance in his FirePay account, and he could transfer his FirePay funds to either his Wells Fargo account or his online poker accounts. It also appears that FirePay charged fees to transfer funds. As such, FirePay acted as “a licensed sender of money or any other person who engages as a business in the transmission of funds” under 31 U.S.C. §5312(a)(2)(R) and therefore qualifies as a “financial institution.”” The account is located in a foreign country and the holder is regulated by the U.K.

In contrast, the 9th Circuit Court found that the other two gaming accounts – PokerStars and PartyPoker were not the type of account required to be reported on an FBAR. The only

purpose these accounts served was to enable Hom to play poker. The court dismissed the IRS argument that the gaming institutions were like banks because they did not meet the definition of a bank per the dictionary. The court distinguished the IRS position in footnote 3 of its decision:

> "The Fourth Circuit's decision in *United States v. Clines*, 958 F.2d 578, 579 (4th Cir. 1992), is not to the contrary. There, the court, in upholding a defendant's conviction for failing to file FBARs, explained, "By holding funds for third parties and disbursing them at their direction, [the entity at issue] functioned as a bank." Id. at 582. The Government seizes upon that single sentence to argue that holding funds alone is sufficient to qualify an entity as a bank, but this reading fails to consider that the entity at issue in Clines engaged in many traditional banking functions beyond merely holding funds. See id. at 580 (explaining that the services the entity provided the defendant and his business partners included "bookkeeping, accounting, and financial management responsibilities . . . [as well as] investment of funds and management of accounts")."

Relevance to Bitcoin: Perhaps the relevance is that if your bitcoin is held by an exchanger or other type of business located outside of the U.S., you may be considered as having a foreign account to report on FBAR. Congress should determine if virtual currencies pose the risks and concerns that led to the Bank Secrecy rules leading to the FBAR. If they do, the law should be modified to specifically add virtual currencies (and any alternative currencies appropriate to monitor). Also see the *IRS FBAR Reference Guide*, which the 9th Circuit Court made reference to in the *Hom* case. Also see FinCen's instructions.

Form 8938 and §6038D: In the preamble to the final regulations under §6038D released December 12, 2014 (TD 9706), the IRS requested comments on "the proper treatment of virtual currency under section 6038D." As of July 2018, no such guidance has been issued.

FinCEN informally says no FBAR: The AICPA Virtual Currency Task Force asked informally and found that 31 C.F.R. §1010.350(c) "does *not* define virtual currency held in an offshore account as a type of reportable account." See Kirk Phillips, "Virtual currency not FBAR reportable (at least for now)," *Journal of Accountancy*, 6/19/19. This is not a formally announced position though.

k. Foreign currency translation – Assume Tiger Company, a U.S. taxpayer, uses bitcoin to purchase goods online from a vendor in Germany. Must TC convert the bitcoin to Euro and then to dollar, or just use the bitcoin-dollar exchange that TC normally uses for its bitcoin transactions?

l. Charitable contributions – the normal rules for donating non-cash property should apply. If VC valued at over $5,000 is donated, a qualified appraisal is needed (§170(f)(11)). An exception exists for publicly-traded securities listed on an exchange with quotations published daily. Since bitcoin has exchange values published, can it be added to this exception? If yes, can the IRS do that or must Congress do so?

m. IRA and Retirement Accounts – Are there any restrictions or issues of holding virtual currency in an IRA or other retirement account?

n. Like-kind? Is one VC considered like-kind to another VC for §1031 purposes? Is a VC considered like-kind to any other type of investment property? Per 1.1031-1(b), "As used in section 1031(a), the words *like kind* have reference to the nature or character of the property and not to its grade or quality." Similarly, see 1.1031-2(c)(1) on intangible personal property.

In Rev. Rul. 82-166,[3] the IRS held that gold bullion was not like-kind to silver bullion even if both were held for investment because the nature of the underlying metals was different, and as metals, gold and silver are used differently. In Rev. Rul. 82-96, the IRS held that gold bullion was like-kind to Canadian Maple Leaf gold coins. Because the Canadian coins were not "a circulating medium of exchange" because the value of their gold content was greater than the face value of the coin. Thus, both types of gold were considered bullion-type coins and "like-kind." Other rulings on this topic from the IRS are summarized in this article: Nellen, Bitcoin taxation - clarity and mystery, *AICPA Tax Insider*, 6/12/14.

Reg. §988-2 (a)(1)(ii) on computation of exchange gain or loss on foreign currency states: "*Clarification of section 1031.* An amount of one nonfunctional currency is not "property of like kind" with respect to an amount of a different nonfunctional currency." Because the IRS says that virtual currency is not "currency," this likely does not apply. Is the §988 rule due to operation of the statute or because the IRS does not find there are like kind features among currencies of different countries?

Arguably, if two VCs have the same features and uses, are both decentralized, they should be considered like kind. Guidance from the IRS would be helpful to know if they have particular features that should be examined to know if two VCs are like-kind.

Note: The Tax Cuts and Jobs Act (PL 115-97; 12/22/17) provides that for exchanges completed after 12/31/17, §1031 only applies to real property. But, guidance is still needed from the IRS for virtual currency exchanges made prior to this date. This is an important issue because §1031 is a mandatory provision when applicable. The answer is also relevant in states that have not conformed to this TCJA change. For example, in California, the pre-TCJA version of §1031 applies to individuals with AGI under $500,000 ($250,000 for single taxpayers).

o. Wash sale rule of §1091, Loss from wash sales of stock or securities – This rule disallows (defers) the loss from the sale of stock or securities if within a 30-day period before or after that date, substantially identical stock or securities are acquired. Does this apply to virtual currency? It would seem that the answer is no as virtual currency is not a security. However, ICO (initial coin offerings) or tokens might be securities per the SEC's "Howey" test. Also see remarks of SEC Director Hinman – "Digital Asset Transactions: When Howey Met Gary (Plastic)" in June 2018, distinguishing when a digital asset may or may not be a security.

Also see Conlon, et al, "Bitcoin, and Wash Sales, and Straddles: Oh My!" *Tax Notes*, 7/23/18, p 505, for a detailed legal analysis of how broadly §1091 might be interpreted.

This is another area in need of guidance from the IRS.

[3] This ruling ties to GCM 38899 (9/27/82).

p. Asset management and loss: Bitcoin is represented by an address. That address might be stored by the owner in a computer file, wallet only or recorded on a piece of paper. Individuals will want to be sure their bitcoin asset is known to be part of their assets for purposes of documenting transactions, transfer upon death, as a measure of their assets (such as needed for estate tax or bankruptcy or solvency measure).

   Also, if bitcoin or other VC is lost, such as due to carelessness, it is unlikely to be considered an "other casualty" for §165 purposes. What about if it is lost due to a hard drive crash (was it sudden, unexpected, or unusual (Rev. Rul. 72-592))?

q. What about a de minimis rule – Even if a taxpayer has a nominal amount of VC, it will need to track the basis when acquired and the FMV when used. Query: Section 988(e)(2) allows up to a $200 per transaction gain exclusion for exchange rate gain if derived from a "personal transaction." Can the IRS create a de minimis rule or would Congress have to do so? Of course, the §988(e) rules require tracking to know if one has a gain over $200. What about a de minimis rule that an individual can exclude VC gains and losses if at no time during the tax year the taxpayer owns more than $x of VC? Such a rule would benefit an individual with, for example, a bitcoin wallet that never has more than $200 FMV and is only used for small transactions. Such a rule likely needs to come from Congress, rather than the IRS.

   In a 5/17/17 letter to the IRS from Senator Hatch and Congressman Brady voicing their concerns that the IRS summons issued to Coinbase was too broad, they ask the IRS: "Will the IRS consider a de minimis exemption or other action to remove practical obstacles to such moderate, transactional use of digital currencies?"

   Bills have been introduced in Congress to provide a de minimis rule, such as H.R. 2144 (116th Congress).

Dealing with the Tax Issues

- Consider for federal tax purposes that bitcoin is "property" and follow the rules that exist for other types of property.

  Per Notice 2014-21, Q&A 1 – "General tax principles applicable to property transactions apply to transactions using virtual currency."

- Find out the purpose of any particular rule you are dealing with and consider how that purpose can be met in how to treat the bitcoin or other VC.

- Seek a letter ruling from the IRS.

Practical Considerations of Bitcoin and other Virtual Currencies

r. Dealing with uncertainty regarding issues noted above and others.

s. Understanding a client's transactions, which likely involve the need to understand technical (for example, software and algorithms) of the VC and the legal arrangement and economic substance of the transaction.

t. Tracking the basis and FMV of VC when used and getting this information efficiently reported on the tax return. Software tools exist to assist (such as Libratax).

u. A business that accepts bitcoin or other VC from customers will need to determine its tax consequences. If it is handling the transactions through its own wallet, there should not be any tax consequence until the business uses the VC. If the business is using an exchanger or payment processor to convert the bitcoin to dollars (similar to a company that processes credit card transactions), the details of the arrangement should be reviewed to determine who has the gain or loss for the time between receipt of the bitcoin or VC and its conversion into dollars – the merchant or exchanger.

v. Vendors who take bitcoin or other VC may need to get more information from the customer if the goods or services sold are subject to sales tax and the vendor needs to know if it is required to collect in that jurisdiction (if it has nexus). If any type of 1099 reporting is required, the issuer needs to get the taxpayer identification number.

w. Ethics: Some people think bitcoin or other VCs are a way to hide income or money from the government. A bitcoin transaction can be completed without the merchant knowing the customer's name. However, depending on the transaction, there may be other documentation (such as when goods are shipped to the customer). Tax preparers should be cautious if clients indicate they are using VC for tax planning purposes. Also, individuals who convert bitcoin or other VC to dollars or vice versa for people, may be required to register with the Treasury Department per the Bank Secrecy Act (see FIN-2013-G001) and state law (such as governed by the California Department of Business Oversight) to avoid violating the law. (For example, see California CBO, *What You Should Know About Virtual Currencies*.)

   If your client pays vendors or employees with virtual currency, you may want to check if the client has verified if any federal or state labor or compensation laws apply to them. Some states have special rules about pay cards.

   If concerned about a client's activities, such as because they are unaware of possible regulation applicable to their exchange activities, you should refer them to an attorney.

x. There are several types of "alternative" currencies besides bitcoin.[4] Some of these are similar to bitcoin in that they are decentralized cryptocurrencies. Others operate much differently and might even be more similar to coupons or gift cards than to bitcoin. For example, in 2006, a community in Massachusetts created "BerkShares" "for community empowerment, enabling merchants and consumers to plant the seeds for an alternative economic future for their communities." See the BerkShares, Inc. website for details. This "alternative currency" does not pose the same issues or tax concerns as bitcoin. Per the BerkShares website, a person can acquire BerkShares (which appear to always be on paper) at a bank for 95 cents on the dollar. The Berkshares can then be used at any merchant who

[4] "Alternative currencies" is a term that was used in an Assembly analysis of California AB 129 (Chapter 74 (6/28/14) to repeal §107 of the Corporations Code that had made it unlawful for a corporation, association or individual to issue or put into circulation anything that acted as money that was not "lawful money of the United States." Among alternative currencies listed were BerkShares, Equal Dollars, Starbuck Stars and Linden dollars.

accepts them. Thus, for example, someone could buy a $100 restaurant meal for $100 of Berkshares, although they only paid $95 for the $100 of Berkshares. For tax purposes, this should be treated as just a price adjustment with no tax consequences to either party (in substance, this is really the merchants agreeing to take something equivalent to a dollars off coupon from these customers). The restaurant has a sale for $95 and the customer spent $95 (because when the restaurant takes the $100 Berkshares to the bank, it will only get $95 of US dollars). The goal of Berkshares is to encourage people to spend money in their community. For information on other VCs, see "Bitcoin Vies with New Crypocurrencies as Coin of the Cyber Realm," by Morgen Peck, *Scientific American*, 4/29/14, and various websites about these VCs.

Due Diligence for Tax Practitioners

- Ask all clients if they mine, own or use any virtual currency.
- Follow Notice 2014-21 to determine tax consequences. The IRS statement in this notice that virtual, convertible currency is property is helpful although not completely as noted in the various issues above.
- Determine if any gift or donation was made using virtual currency.
- Help client with recordkeeping to track value every time the virtual currency is used or obtained. Software exists to help with this, such as LibraTax.
- If client exchanges virtual currency for sovereign currency with customers, ask if he or she has reviewed applicable federal and state registration rules. This question can help you gauge your client's awareness of legalities associated with this activity, which may also affect determination of business versus hobby status.

Additional Information

- AICPA comment letter of 6/10/16 on Notice 2014-21.
- AICPA comment letter of 5/30/18 with questions and suggested answers in 12 areas including treatment of a fork or split or airdrop.
- Nellen, Bitcoin taxation - clarity and mystery, *AICPA Tax Insider*, 6/12/14.
- Taxation and Today's Digital Economy, CCH's *Journal of Tax Practice & Procedure*, May-June 2015
- *Overview of Internet Taxation Issues* - published by BloombergBNA Internet Law Resource Center (2014) (95 pages)
- Nellen, Virtual Currency and Taxation website – links to tax information (US and foreign countries), government reports and hearings, background information on virtual currency, and more. http://www.21stcenturytaxation.com/virtual-currency-and-tax.html