

# Tax Considerations of Convertible Virtual Currency Transactions

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In recent years, an increasing number of U.S. taxpayers have begun to utilize “virtual currency,” such as Bitcoin, as an investment vehicle or to pay for goods and services. As virtual currencies have grown, so have questions related to their taxability—so much so, that the IRS issued Notice 2014-21 on March 25, 2014 to provide guidance on the tax implications of using virtual currency. Although not all possible collateral tax implications were addressed, this notice afforded a great start to understanding how one should evaluate transactions in virtual currency.

Virtual currency is best defined by the U.S. Department of the Treasury in FIN-2013-G001 as “a medium of exchange that operates like currency in some environments, but does not have all the attributes of real currency.” It further specifies that virtual currency does not have legal tender status in any jurisdiction. Although there are several variations of virtual currency, this article and IRS Notice 2014-21 address “convertible” virtual currency (CVC). CVC is a virtual currency that either has an equivalent value in real currency or acts as a substitute for real currency. In other words, CVC can be directly valued in real currency through markets or exchanges and is often readily converted to legal tender. If a CVC is listed on an exchange, and the exchange rate is established by market supply and demand, for IRS purposes, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars at the exchange rate, in a reasonable manner consistently applied.

## Tax Considerations of CVC Transactions

The IRS considers CVC as property. Accordingly, the tax principles associated with property transactions apply to CVC transactions.

Either when using CVC to purchase goods and services, or when accepting them in payment for goods and services, one could essentially think of the transaction as a barter transaction. If a taxpayer is accepting CVC in exchange for goods or services, the CVC and the corresponding gross income must be valued in U.S. dollars as of the date of payment or receipt. This valuation concept can create significant effort and recordkeeping for a high-volume retailer or contractor who accepts CVC due to the high volatility in CVC values.

If a taxpayer is utilizing CVC to purchase goods and services, each transaction must be treated as a sale or exchange of property. The purchaser must recognize gain or loss on the exchange of CVC for the goods and services with each transaction. The gain or loss is determined by comparing the basis of the CVC used in the transaction to the fair market value of the property or services received. The basis of items purchased is the fair market value when purchased. Careful recordkeeping and tracking is necessary for a taxpayer to not only properly report gains and losses for CVC transactions, but to also minimize gain.

The character of the gain or loss from a CVC transaction depends on the characterization of the CVC in the hands of the taxpayer as well as the holding period. Capital gains and losses are recognized if the CVC is considered a capital asset in the hands of the taxpayer. If CVC is considered inventory or other property held for sale to customers in a trade or business, then gain or loss on such transactions would be ordinary. If CVC is not held for investment or in the ordinary course of business, i.e., “personal use,” losses from CVC transactions will not be deductible. Gains, on the other hand, would still be taxable. Practitioners should strive to assist their clients in evaluating the appropriate facts and circumstances to ensure the proper tax treatment.

### Mining CVC

Mining CVC describes an activity where CVC is “earned” by using computer resources to validate historical CVC transactions. When earned through mining activities, a taxpayer recognizes income equal to the fair market value of the CVC earned on the date received. Depending upon the status of the taxpayer and form of organization, the net earnings from mining activities also may be subject to self-employment tax.

### Wages Paid in CVC

If an employer pays wages in CVC, the amount of the wages for all purposes is the fair market value of the CVC paid on the date of payment. The employee, of course, receives wages valued under the same principles. As with previous examples, the CVC must be converted to U.S. dollars on each pay date at the prevailing exchange rate, adding another layer of complexity to the payroll process.

### Other Payments in CVC

Information reporting is required for all payments in CVC,

just as any payment in any other type of property would be required. This includes rent, premiums, annuities, compensation, and payments to independent contractors. The appropriate 1099-Misc or other applicable form is still required. The reportable amount is the fair market value of the CVC payment as of the date of payment. Backup withholding and taxpayer identification number (TIN) reporting also is required as if the payments were made in legal tender.

### CVC as Foreign Financial Assets Subject to Disclosure

Currently, it is unclear whether convertible virtual currency constitutes assets required to be disclosed on Foreign Bank and Financial Reports (FBAR) or Form 8938, Statement of Specified Foreign Assets. The decision to disclose is based on whether a convertible virtual currency is considered a financial asset or cash, and if it is held in foreign accounts. Although IRS Notice 2014-21 specifies that convertible virtual currency is property, careful consideration should be made of all foreign asset reporting rules and definitions to ensure compliance. It is recommended that practitioners watch for current IRS statements and announcements to ensure the latest guidance is considered.

### Conclusion

The introduction of CVC as an innovative mode of commerce has required tax practitioners and the IRS to address many new tax questions. Although some answers have been provided through IRS guidance, tax advisors must be aware of situations for which clear cut answers do not exist. In striving to serve their clients, advisors will increasingly be called on to exercise professional judgment and stay current in the evolving methods of commerce as well as the related tax rules.

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