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April 2014

### Regulatory and Tax Issues Posed By Convertible Virtual Currencies

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And the answer is – Property.

Not surprisingly, the question is how Convertible Virtual Currencies (CVCs) such as Bitcoin should be classified for tax purposes. Given the treatment of CVCs by the Financial Crimes Enforcement Network (FinCEN) in **FIN-2013-G001**, it is not surprising that the Internal Revenue Service also concluded that CVCs constitute property in the recently released **IRS Notice 2014-21**. The implications of this on U.S. users of CVCs are immediate and potentially very expensive.

In FIN-2013-G001, FinCEN distinguished between real currency, which is comprised of coin and paper money of the United States or other countries that is designated as legal tender by those countries; and CVCs, which are like real currency but do not have all of the attributes of real currency including legal tender status in any jurisdiction. FinCEN set out the rules applicable to transactions involving and parties to CVCs.

Mere users of CVCs are not engaged in a money service business (MSB), and thus do not need to register, report, or keep records pursuant to the FinCEN regulations for MSBs. An example of "mere users" is the individual who buys CVCs for personal use, or a business that accepts CVCs as payment, such as Overstock.com or the Sacramento Kings.

Administrators and exchangers who accept and transmit CVCs or who buy or sell CVCs, however, are money transmitters and thus subject to FinCEN's MSB regulations, unless a limitation or exemption applies to such persons. This puts companies that accept CVC for payment but do not immediately monetize the CVC in an interesting – and potentially gray – area. Issues here may well only be resolved through case and controversy in the tax system.

While some have tried to argue that a de-centralized virtual currency with no central repository and no single administrator should not be included in the provisions applicable to MSBs, FIN-2013-G001 specifically provides that administrators or exchangers of both centralized and decentralized CVCs will be treated as MSBs. (In this regard, it might be noted that FinCEN's MSB category is becoming the "catch all" for emerging payment technologies and methods – prepaid access (gift and stored value), and now CVCs, fall under the MSB rubric.) Based upon recent articles, we understand that U.S.-based Bitcoin operators are seeking to register with FinCEN and the appropriate state regulatory authorities as MSBs so as to provide regulatory compliant CVCs to U.S. persons.

Bitcoins have been the subject of review by the tax and regulatory authorities in a number of countries. Russia has banned the use of Bitcoins; Australia is keeping a close eye on the use of Bitcoins saying thus far that use does not raise any issues that do not also arise from physical currencies or other emerging payment systems; Canada issued a fact sheet in November 2013 clarifying that existing tax rules, including the barter rules, apply to CVC transactions. In addition, a number of countries have clarified that transactions involving CVC are subject to their Value Added Tax rules. Thus far, however, few countries have attempted to regulate the use of CVCs other than Japan, Russia, Estonia, and the U.S.

For U.S. federal tax purposes, and thus most state tax purposes, most tax advisors who have addressed the tax issues arising from the use of CVCs to pay for goods and services have analogized them to transactions involving property that can appreciate or depreciate in value. This approach has been followed by the IRS in Notice 2014-21.

Accordingly, recipients of CVCs from selling goods or providing services should recognize income equal to the fair market value of the CVCs as of the date of receipt. Persons paying for goods or services with CVCs should recognize gain or loss equal to the difference between the value of the goods or services received and their tax basis in the CVCs exchanged. For example, an individual who purchases a unit of a CVC for \$50 but buys goods worth \$100 with that unit (due to appreciation in value of the CVC) also

has a reportable gain of \$50. Furthermore, the "mining" of CVCs by a person requires the inclusion in income by such person of an amount equal to the CVC on the date mined.

The tax basis of CVCs is determined under the generally applicable rules, so that recipients or miners of CVCs obtain a Fair Market Value basis in the received or mined CVCs, while purchasers of CVCs take a cost basis.

The rules applicable to information reporting apply equally to transactions involving CVCs, so Form 1099-MISC or Form W-2 may need to be issued by those persons hiring independent contractors or employees and paying them with CVCs.

From the commercial and trade press, it appears that few miners or traders of CVCs keep or maintain records that will allow compliance with IRS Notice 2014-21. It may be that these individuals and companies think that the current anonymity associated with CVCs will keep the tax collectors away from their doors. We would suggest that in view of FinCEN's focus on bringing CVCs into the mainstream of financial products, this reliance is misplaced.