

**VI. *Bitcoin: Assessing the Tax Implications Associated with the IRS's Notice Deeming Virtual Currencies Property***

**A. Introduction**

Recently, there has been considerable controversy over how the federal government should treat Bitcoin for federal tax purposes.<sup>1</sup> Many Bitcoin holders argued that the Internal Revenue Service ("IRS") should deem Bitcoin "property" like a stock or a bond, while others argued that the IRS should tax Bitcoin like a "currency."<sup>2</sup> The difficulty is that, in reality, Bitcoin has many characteristics of both property and currency.<sup>3</sup> While some Bitcoin holders use their Bitcoins exactly like currency to directly purchase goods and services, Bitcoin is unlike other currencies because it is not created and backed by a central government.<sup>4</sup> The IRS ended this debate in March of 2014, by declaring that the federal government will tax Bitcoin and other virtual currencies as property.<sup>5</sup>

This Article will outline some of the tax implications associated with the IRS decision to tax Bitcoin as property. Part B of this Article will provide background on Bitcoin. Part C will examine the IRS's decision to tax Bitcoin, and other virtual currencies, as property. Part D will consider the tax implications associated with the IRS's decision.

**B. Background**

Bitcoin is a virtual cryptocurrency.<sup>6</sup> Bitcoin's alleged creator, Satoshi Nakamoto, created a software program that uses cryptography

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<sup>1</sup> See Kim Lachance Shandrow, *IRS Will Tax Bitcoin, Says It's Not Currency*, ENTREPRENEUR (Mar. 25, 2014), <http://www.entrepreneur.com/article/232541>, archived at <http://perma.cc/HL64-TAUA>.

<sup>2</sup> *Id.*

<sup>3</sup> See Nicole Mirjanich, Note, *Digital Money: Bitcoin's Financial and Tax Future Despite Regulatory Uncertainty*, 64 DEPAUL L. REV. 213, 237-42 (2014).

<sup>4</sup> *Id.* at 213.

<sup>5</sup> Shandrow, *supra* note 1.

<sup>6</sup> Joshua Davis, *The Crypto-Currency: Bitcoin and its Mysterious Inventor*, NEW YORKER (Oct. 10, 2011), <http://www.newyorker.com/magazine/2011/10/10/the-crypto-currency>, archived at <http://perma.cc/AV5Z-PBSX>.

to render each Bitcoin and Bitcoin transaction uniquely identifiable.<sup>7</sup> Nakamoto's unique software program ensures that duplicate coding cannot be created.<sup>8</sup> Each unique Bitcoin has a value that can be used to purchase goods and services.<sup>9</sup> The main difference between "virtual" and "regular" currency is that virtual currency does not have a fixed monetary value created by a government.<sup>10</sup> Instead, it has a monetary value that is determined by basic principles of supply and demand.<sup>11</sup> The Bitcoin software allows the creation of 21 million Bitcoins, after which the software will not allow any more Bitcoins to be created.<sup>12</sup>

Potential users obtain Bitcoins either by "mining" or by purchasing the Bitcoin from a current Bitcoin holder.<sup>13</sup> After Nakamoto's software creates a Bitcoin, it floats freely on the Internet, waiting to be claimed by a "miner."<sup>14</sup> "Miners" are individuals who go "fishing" or "mining" for virtual coins on the Internet to claim as their property.<sup>15</sup> Once mined, traders buy and sell the Bitcoins like any other good.<sup>16</sup> Bitcoin holders store their Bitcoins in "digital wallets."<sup>17</sup> The identities of the people who own Bitcoins remains unknown because the digital wallets do not identify their owners by their real names.<sup>18</sup> As such, transactions between parties using Bitcoin have the potential to be

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<sup>7</sup> See *id.*

<sup>8</sup> *Id.*

<sup>9</sup> See *id.*

<sup>10</sup> See Lyndsey Gilpin, *10 Things You Should Know About Bitcoin and Digital Currencies*, TECH REPUBLIC (May 21, 2014, 4:00 AM), <http://www.techrepublic.com/article/10-things-you-should-know-about-bitcoin-and-digital-currencies/>.

<sup>11</sup> See Michael J. Casey, *Bitcoin's Plunge Bites 'Miners': As Value Falls, Some Pull Plug on Computers Supporting System*, WALL. ST. J. (Jan. 14, 2015, 10:16 PM), <http://www.wsj.com/articles/bitcoins-plunge-bites-miners-1421281616>.

<sup>12</sup> Davis, *supra* note 6.

<sup>13</sup> Gilpin, *supra* note 10.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> See *id.*

<sup>18</sup> See Andy Greenberg, *Dark Wallet Aims to be the Anarchist's Bitcoin App of Choice*, FORBES (Oct. 31, 2013, 9:40 AM), <http://www.forbes.com/sites/andygreenberg/2013/10/31/darkwallet-aims-to-be-the-anarchists-bitcoin-app-of-choice/>.

anonymous.<sup>19</sup> In many cases, Bitcoin holders have used the currency's anonymity to engage in illegal transactions.<sup>20</sup>

### C. IRS Notice Deems Bitcoin a Property Asset

In March of 2014, the IRS announced that it would treat virtual currencies, including Bitcoin, like "property" for tax purposes.<sup>21</sup> The IRS announcement means that "[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency."<sup>22</sup> In other words, the IRS determined that virtual currency is an asset in the hands of the owner, like stocks or bonds in the hands of an investor.<sup>23</sup> IRS Notice 2014-21 ("IRS Notice") further explained that "[t]he character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer."<sup>24</sup> Therefore, if a taxpayer holds the virtual currency for more than one year, it qualifies as a long-term capital asset, and the disposition of the property will implicate a preferential capital gains rate.<sup>25</sup> Alternatively, if the virtual currency does not qualify as a long-term capital asset, it will implicate ordinary income tax rates.<sup>26</sup>

The IRS Notice provides guidance on how taxpayers may solve this substantive issue of law for annual filing purposes.<sup>27</sup> Importantly, the IRS Notice legitimizes Bitcoin, or any virtual currency for that matter, by deeming it a property asset, thereby eliminating the

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<sup>19</sup> See Susannah Nesmith, *Miami Bitcoin Arrests May Be First State Prosecution*, BLOOMBERG (Feb. 10, 2014, 1:27 PM), <http://www.bloomberg.com/news/articles/2014-02-09/miami-bitcoin-arrests-may-be-first-state-prosecution>, archived at <http://perma.cc/ZF4X-45WN>.

<sup>20</sup> See *id.*

<sup>21</sup> I.R.S. News Release IR-2014-36 (Mar. 25, 2013), available at <http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance>, archived at <http://perma.cc/DQZ8-VQCZ>; I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 (Apr. 14, 2014).

<sup>22</sup> I.R.S. Notice 2014-21, *supra* note 21, at 938.

<sup>23</sup> See *id.*

<sup>24</sup> *Id.* at 939.

<sup>25</sup> See *id.*

<sup>26</sup> See *id.*

<sup>27</sup> See *Understanding IRS Guidance – A Brief Primer*, IRS, <http://www.irs.gov/uac/Understanding-IRS-Guidance-A-Brief-Primer> (last updated Jan. 23, 2015), archived at <http://perma.cc/795K-HNTB>; see also I.R.S. Notice 2014-21, *supra* note 21, at 938.

fear that virtual currency may be “illegal.”<sup>28</sup> The IRS Notice also includes a “frequently asked questions” section that addresses taxpayers’ potential questions relating to virtual currency, and provides information taxpayers can use to handle virtual currency taxation problems.<sup>29</sup>

#### **D. Analysis**

However, the problem with the IRS Notice deeming Bitcoins to be “property” is that, in reality, Bitcoins function both as property and as currency, which creates many tax-related issues.<sup>30</sup> Despite the IRS’s decision, Bitcoin holders often use Bitcoins as a currency to purchase goods and services.<sup>31</sup> Bitcoin differs from a typical “property asset” such as a stock, which can only be traded and bartered.<sup>32</sup> Bitcoin can function like property, as its holders often trade and barter with it, but its holders also frequently use Bitcoins as currency to directly purchase goods and services.<sup>33</sup> In the future, the IRS will have to clarify several tax problems associated with the federal taxation of Bitcoin.

#### **1. Tax Evasion Issue**

The first, and perhaps most serious problem, is that Bitcoin creates a serious tax evasion issue.<sup>34</sup> In the eyes of some observers, Bitcoin threatens to become the new “offshore banking system,” that Bitcoin holders could use to avoid taxes on capital gains.<sup>35</sup> It can be used as a tax haven because, in many respects, Bitcoin allows for the complete anonymity of its holders and traders.<sup>36</sup> It will be difficult for the IRS to confirm what “gains” or “losses” are realized from the

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<sup>28</sup> See I.R.S. Notice 2014-21, *supra* note 21, at 938.

<sup>29</sup> *Id.* at 938-40.

<sup>30</sup> See generally Mirjanich, *supra* note 3.

<sup>31</sup> See Davis, *supra* note 6.

<sup>32</sup> See *id.*

<sup>33</sup> I.R.S. Notice 2014-21, *supra* note 21, at 938.

<sup>34</sup> Mirjanich, *supra* note 3, at 222.

<sup>35</sup> Omri Marian, Commentary, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38, 38-39 (2013); Josh Ungerman, *Are Virtual Currencies the Next Offshore Bank Account for Tax Evaders?*, FORBES (Oct. 3, 2014, 11:18 AM), <http://www.forbes.com/sites/irswatch/2014/10/03/are-virtual-currencies-the-next-offshore-bank-account-for-tax-evaders/>.

<sup>36</sup> Marian, *supra* note 35, at 39.

Bitcoins because it is very difficult, if not impossible, to determine the identity of Bitcoin owners.<sup>37</sup> Therefore, if a Bitcoin holder fails to properly report his Bitcoin gains or losses on his federal tax return, the IRS may be unable to conduct a thorough and complete audit, and the taxpayer may successfully evade taxation on those gains and losses.<sup>38</sup> In response to these concerns, the IRS has empaneled a team of “Special Agents” to “master Bitcoin and other virtual currencies” and stop “would-be tax cheats.”<sup>39</sup>

## 2. Basis Issue

Another administrative problem with taxing Bitcoins is that it is very difficult for the taxpayer or the IRS to determine the “basis” of a Bitcoin because a person can purchase virtual currencies at different times, from different sources, and at different price rates.<sup>40</sup> Take, for example, someone who purchases a Bitcoin at a value of \$100. The person proceeds to buy another type of virtual currency at a value of \$150. Two years later, the person decides to sell some of his virtual currency for \$160. What basis value will be used to determine the gain?<sup>41</sup> The \$100? If that is the case, then the gain will be \$60, yet part of the “property” was purchased for \$150. As a result, the IRS might over-tax the virtual currency holder on their gain, which could be either \$60 or \$10.<sup>42</sup> Alternatively, a taxpayer could cheat the tax system by claiming a basis value of \$150 and reporting a gain of only \$10.<sup>43</sup> In such a case, it would be extremely difficult for the IRS to track down the records required to sufficiently audit the taxpayer, and the taxpayer would likely evade taxation.<sup>44</sup>

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<sup>37</sup> *Id.* at 42.

<sup>38</sup> *See id.*

<sup>39</sup> Ungerman, *supra* note 35.

<sup>40</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-516, VIRTUAL ECONOMIES AND CURRENCIES: ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS (2013).

<sup>41</sup> *See* Josh Ungerman, *IRS Approach to Taxation of Bitcoin*, FORBES (Dec. 4, 2014, 1:02 AM), <http://www.forbes.com/sites/irswatch/2014/12/04/irs-approach-to-taxation-of-bitcoin/>.

<sup>42</sup> *See id.*

<sup>43</sup> *See id.*

<sup>44</sup> *Id.*

In addition, it will be difficult for taxpayers and the IRS to determine the basis value of Bitcoins held by miners.<sup>45</sup> Recall from above that miners are individuals who mine Bitcoins on the Internet.<sup>46</sup> According to the IRS Notice, the basis value of the Bitcoins they mine is determined by the market price at the time the Bitcoin is mined.<sup>47</sup> Let's suppose that on day one, the miner mined ten Bitcoins, and that the going market rate on that day was \$1000 for each. Then on the second day, the miner mined another ten Bitcoins, and the going market rate on that day was \$1500. On day three, the miner mined another Bitcoin with a going market rate of \$2000. Several weeks later, the miner decides to sell ten Bitcoins. Once again, the basis value will be virtually impossible to determine because the miner will not know what basis value to use for each coin.<sup>48</sup>

### 3. Capital Gains Issue

Because taxpayers will have difficulty determining the basis value of Bitcoins, it will also be difficult for the taxpayer to determine how to treat certain Bitcoins for purposes of capital gains.<sup>49</sup> The IRS Notice specifies that “[i]f the fair market value of property received in exchange for virtual currency exceeds the taxpayer’s adjusted basis of the virtual currency, the taxpayer has taxable gain.”<sup>50</sup> The tax code imposes a tax on these taxable gains.<sup>51</sup> The problem is that, if the taxpayer is unable to calculate his basis in the Bitcoins, he will be unable to accurately determine whether he has accrued any “capital gains,” and the IRS’s entire scheme for taxing Bitcoin will break down.<sup>52</sup> The IRS Notice provides no guidance on how to solve this potentially enormous issue.<sup>53</sup>

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<sup>45</sup> See Jonathan Marino, *Bitcoin Will Be a Big Mess for Both Bitcoin Holders and the IRS*, BUSINESS INSIDER (Feb. 19, 2015, 3:11 PM), <http://www.businessinsider.com/bitcoin-will-be-a-big-headache-for-both-bitcoin-holders-and-the-irs-2015-2>, archived at <http://perma.cc/K5QF-TG46>.

<sup>46</sup> See *supra* text accompanying notes 13-17.

<sup>47</sup> See I.R.S. Notice 2014-21, *supra* note 21, at 938-39.

<sup>48</sup> See Ungerman, *supra* note 41.

<sup>49</sup> I.R.C. § 1001(a) (2012)

<sup>50</sup> See I.R.S. Notice 2014-21, *supra* note 21, at 939.

<sup>51</sup> See I.R.C. § 1001(a).

<sup>52</sup> See *id.*

<sup>53</sup> See generally I.R.S. Notice 2014-21, *supra* note 21.

### **E. Conclusion**

The IRS Notice announced that the IRS would treat Bitcoins like property for tax purposes, but it failed to consider several potentially important problems with this taxation scheme.<sup>54</sup> Difficulty in tracking Bitcoin ownership may result in rampant tax evasion.<sup>55</sup> Furthermore, if taxpayers are unable to calculate and track their basis in Bitcoins, it will be impossible for the IRS to tax the capital gains and losses associated with Bitcoins.<sup>56</sup> Ultimately, the IRS Notice may raise more questions than it answers. The discussion above merely raises the most obvious issues associated with the IRS Notice, with many more issues sure to arise as taxpayers try to comply with the IRS's Bitcoin taxation scheme.

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<sup>54</sup> See *supra* text accompanying notes 30-53.

<sup>55</sup> See *supra* text accompanying notes 34-39.

<sup>56</sup> See *supra* text accompanying notes 40-53.

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