

IRS Issues Significant Convertible Virtual Currency Ruling – Bitcoin Community Abuzz

By James G. Gatto

The IRS has issued its first major ruling on the U.S. federal tax implications of transactions in, or transactions that use, Bitcoin and other convertible virtual currencies. The ruling stresses that it relates to convertible virtual currencies¹.

One of the most significant pronouncements of the notice is that the IRS has determined that virtual currency is treated as property for U.S. federal tax purposes and therefore general tax principles that apply to property transactions apply to transactions using virtual currency. The notice indicates that this means that:

- Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes.
- Payments using virtual currency made to independent contractors and other service providers are taxable and self-employment tax rules generally apply. Normally, payers must issue Form 1099.
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
- A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.

In a set of FAQ's issued in conjunction with the notice, the IRS also indicated the following:

- Convertible Virtual Currency is a virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, such as Bitcoin.



¹ The ruling notes that "In some environments, virtual currency operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction."

- In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability.²
- Virtual currency is not treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws.

Computing Gross Income - For purposes of computing gross income, a taxpayer who receives virtual currency as payment for goods or services must include the fair market value of virtual currency received as measured in U.S. dollars, as of the date that the virtual currency was received.

Basis - The basis of virtual currency received as payment for goods or services is the fair market value of the virtual currency in U.S. dollars as of the date of receipt.

Fair Market Value - For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.

Tax Implications of Exchanging Virtual Currency - If 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. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.

Character of gain or loss - The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset.

Taxability of Mining - when a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income.

Employment Tax on Mining - If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax.

Payments to Independent Contractors - Generally, self-employment income includes all gross income derived by an individual from any trade or business carried on by the individual as other than an employee.



² The notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term "virtual currency" as used refers only to convertible virtual currency. No inference should be drawn with respect to virtual currencies not described in this notice.

Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.

Employee Taxation - Generally, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, Wage and Tax Statement.

Reporting - A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of \$600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities, and compensation.

1099s - Generally, a person who in the course of a trade or business makes a payment of \$600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, Miscellaneous Income. Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in U.S. dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC.

Backup withholding - Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payor must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required.

Payment Settlements - In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, Payment Card and Third Party Network Transactions, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds \$20,000.³ When determining whether the transactions are reportable, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.

Penalties - Taxpayers may be subject to penalties for failure to comply with tax laws. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under section 6721 and 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.



³ The notice adds that when completing Boxes 1, 3, and 5a-1 on the Form 1099-K, transactions where the TPSO settles payments made with virtual currency are aggregated with transactions where the TPSO settles payments made with real currency to determine the total amounts to be reported in those boxes.

Conclusion

The legal landscape with respect to Bitcoin and other convertible virtual currency continues to evolve at a more rapid pace. Last March, FinCEN issued its now famous virtual currency guidance. Shortly thereafter, a number of high-profile enforcements ensued. If history is any lesson, it is likely that some tax enforcements will follow this ruling. Therefore, miners, exchanges, businesses transacting in Bitcoin and others dealing with virtual currencies should promptly assess this guidance and ensure compliance.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author below.

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