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ON BITCOIN

Voices from the cutting edge

MCC's contributing firms weigh in on the bitcoin phenomena – how it works, legal and privacy implications, and the broader impact of this disruptive technology as non-monetary currency gains acceptance and popularity.

IRS Treatment of Virtual Currencies

Federal and state authorities have been considering a number of tax issues involving the treatment of certain virtual currencies. While virtual currencies act like real currency, there is no physical counterpart. Therefore, the authorities have had to address the fact that virtual currencies are essentially intangible assets. Addressing some of the tax implications of transactions made with bitcoin, ***Michael F. D'Addio*** *of* ***Marcum LLP*** *looks at the question of how this intangible asset can be taxed.*

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The Internal Revenue Service clarified a number of issues concerning the taxation of bitcoin and other "cryptocurrency" last year in Notice 2014-21. However, the guidance also created a number of complexities while imposing significant additional accounting responsibilities.

The IRS has taken the position that bitcoin and other forms of cryptocurrency are not currency (like dollars or euros) and therefore should be treated as personal property. This conclusion produces both positive and negative tax consequences. On the positive side, income earned by investors when they dispose of the virtual currency can produce capital gains treatment depending on how long the investor held the currency. When the coins are held for less than 12 months, regular tax rates will apply to any gain on disposition. However, when the coins are held for more than 12 months, they qualify as capital assets. As capital assets, any gain earned upon a disposition is subject to the preferred (lower) long-term capital gains rates (0 percent, 15 percent and 20 percent) instead of the higher ordinary income rates.

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Unfortunately, the IRS' position of treating virtual currency as personal property also creates some disadvantages for investors. This is because, similar to the gain from a disposition of virtual currencies, the losses resulting from the disposition, sale or exchange of bitcoin or other cryptocurrency are also capital in nature. Therefore, the losses can be used to fully offset any capital gain income, but can only offset up to $3,000 of non-capital gain income a year. Any unused losses may be carried over to future years but will be subject to the same annual limitation in those years. As a result, an investor may have to wait to utilize the full tax benefit of the loss. However, if virtual currency were considered to be foreign currency, any losses from their disposition would be deducted as an ordinary loss.

A question still exists as to whether losses relating to bitcoin and cryptocurrency are subject to the wash sale rules, which are intended to limit the use of losses that have not been economically realized. Under the wash sale rule, when stocks or securities are sold at a loss and substantially identical replacement stocks or securities are purchased within the thirty days either before or after the date of sale, the loss is disallowed in the current year for tax purposes. The tax basis of the replacement asset is then adjusted by the amount of the disallowed loss.

It can be argued that bitcoin and other cryptocurrencies are liquid (like marketable stock and securities) and that replacement coins would be substantially identical to exchanged coins so that the wash sale rule should apply. However, the IRS has previously stated that the wash sale rules apply only to stocks and securities and has not yet identified these virtual currencies as being "stocks" or "securities." It is most likely that the wash sale rules do not apply to losses on the disposition of bitcoin and cryptocurrency. If the IRS or Congress were to change this result, a holder would have to wait 30 days before or after the disposition date before replacing the coins in order to use the loss. This could produce a significant hardship in situations where bitcoins are used as currency to pay for commercial transactions.

There is no income or other gain generated on the purchase of these coins. When they are received in exchange for services performed, there is an immediate tax consequence since the amounts received for services are always subject to tax. Similarly, if the coins are

received in exchange for property transferred, the gain or loss must be calculated with respect to the property transferred and treated under normal tax rules.

The IRS states in the Notice that using virtual currency to pay for a commercial transaction results in a sale or exchange for which a taxable gain or loss must be calculated, based on the difference between their values and acquisition costs. Therefore, the holder of bitcoin and other cryptocurrency must maintain adequate records to determine the cost and holding period of the virtual currency being used. This could result in significant record-keeping issues.

Investors should have the option to select the method to determine which bitcoins are sold – i.e., on a first-in-first-out (FIFO) basis, a last-in-last-out (LIFO) method or specific identification method. The method selected would determine the holding period and basis of the coins sold when computing the gain or loss on the transaction. Choosing one method over another could have a significant tax impact. While specific identification might be the best option, this may not be a practical alternative. In order to use this method, the seller must inform the "broker" which particular units are being sold. It is unclear if the current trading platforms maintain sufficient records and have the ability to execute a transfer of specific coins from a particular purchased lot.

Bitcoin and cryptocurrency have raised a number of issues for state governments as well. For states that piggyback their income tax systems on federal rules, the IRS Notice provides the basic taxation structure. Others will need to address taxation issues separately. Bitcoins are creating other state tax questions. New York recently issued guidance stating that the acquisition of bitcoins is generally not subject to sales tax. This is because New York's sales tax system only applies to tangible personal property, and these virtual currencies are intangible property. However, taxable assets or services purchased with these coins remain subject to sales tax.